Regulatory Solvency Assessment of General Insurance Companies in the United States

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Regulatory Solvency Assessment of General Insurance Companies in The United States

- Global context
- US regulatory approach to solvency assessment of General Insurance companies
  - Current
  - ORSA evolution
- Rating agencies
  - Approach
  - Role

Global Context for
Regulatory Assessment of Solvency

Financial Services Regulation is Coordinated Among International Regulators

The Global Regulation Process

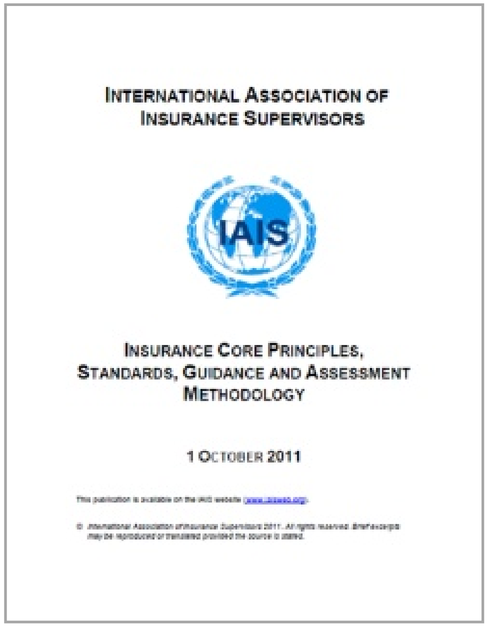
G20	Financial Stability Board, IMF	Basel, IOSCO, IADI, IAIS	National Regulators
High-level assessment, international agreement	“Thematic” analysis overview audit, review	International standards, supervisory principles	National regulation, legislation

- Financial institutions are regulated locally, but principles and standards are developed globally
- Financial regulation generally flows from coordinated international standard setting bodies consisting of regulators from member nations

Source: Davis, Kevin, Regulatory Reform Post the Global Financial Crisis: An Overview. March 2011.

The Strength and Consistency of National Regulation is Regularly Reviewed by the IMF and World Bank

- Financial Sector Assessment Program (FSAP)
  - Comprehensive analysis of a country's financial sector
    – Stability of financial sector
    – Contribution to growth and development
  - Reviews include:
    – Comparison of bank, insurance and financial market supervision to accepted international standards
    – Stress tests to demonstrate ability to withstand economic shifts
    – Evaluation of supervisor and policymaker capacity to respond effectively in systemic stress scenarios
  - FSAP is now mandatory and performed every 5 years for 25 major jurisdictions


INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

IAIS

INSURANCE CORE PRINCIPLES, STANDARDS, GUIDANCE AND ASSESSMENT METHODOLOGY

1 OCTOBER 2011

Insurance Regulatory Approaches and Requirements Vary Across the Globe

Capital Requirements and Solvency Assessments

Specific capital amounts required -- or risk-based capital

Internal models – or standard models

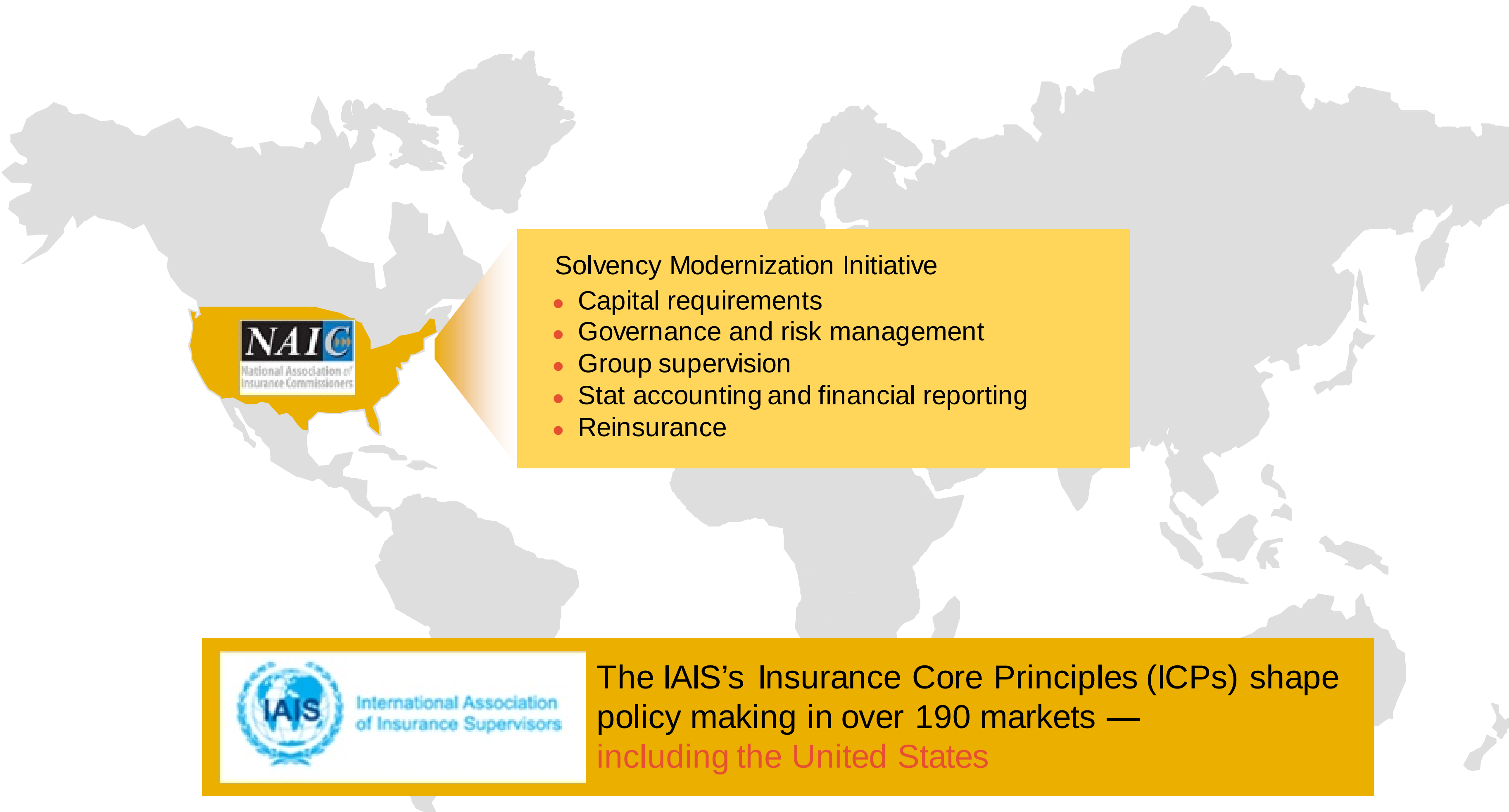
Prescribed calculations – or other measures

Degree of customization to company characteristics

Industry-based standardized inputs – or company-specific metrics

Choice of metrics

Global Regulatory Approaches to Capital and Risk Management are Heading in the Direction of Convergence Around the “ICPs”



Solvency Modernization Initiative

- Capital requirements
- Governance and risk management
- Group supervision
- Stat accounting and financial reporting
- Reinsurance

IAIS International Association of Insurance Supervisors

The IAIS’s Insurance Core Principles (ICPs) shape policy making in over 190 markets — including the United States

ICPs Reflect Regulatory Practices from Leading Insurance Markets but are Heavily Influenced by Solvency II

Pillar I	Pillar II	Pillar III
Measurement of Assets, Liabilities and Capital	Supervisory Review Process	Disclosure Requirements
Asset and Liability Calculation Standards Solvency Capital Requirements	Regulatory Monitoring, Review, and Assessment Tools and Processes Own Risk and Solvency Assessment	Financial and Other Reports to Supervisor Solvency and Financial Condition Report

Regulatory Solvency Assessment of General Insurance Companies in the United States

The US Regulatory Approach Focuses on Solvency Assessments, Enabled by Financial Reporting and Disclosures that are Extensive, Transparent , and Public

Restrictions and constraints on some risky activities

Regulatory financial monitoring and examinations

Insurance company financial reporting and disclosures

Coming soon:

Examination of ORSA

Risk-based capital process

Guaranty funds provide a safety net

General Insurance Companies in the US Have Restrictions on Some Risky Activities

	Outright Restrictions	Accounting and RBC Treatments
Licensing requirements	√	
Minimum capital requirements	√	
Investments	√	√
Reinsurance		√
Loss reserves		√
Risk-based capital parameters and actions	√	√
Regulatory pre-approval requirements	√	
Regulatory “signals”		

At the Core of Regulatory Solvency Assessment of US General Insurance Companies: Extensive, Transparent Public Reporting And Disclosure Requirements

- Extremely detailed financial statements, and related information and disclosures
- Formal actuarial opinion regarding loss reserves
- Most of this information is open to review by "the public" in addition to being reported to regulators

Enables detailed regulatory diagnoses

- Company activities and performance
- Trends
- Risk characteristics
- Balance sheet strength. . .

Statutory Financial Statement Requirements for US General Insurance Companies are Specified in Detail

- Required elements, schedules, formats
- By line of business (also pre-defined)
- Required "statutory accounting" methods
  - Standard across different insurance companies
  - More conservative than GAAP
- Numerous narrative responses to standardized questions (e.g., asbestos and environmental exposure)

Illustrative Statutory Financial Statement Elements – US General Insurance Companies

- Current and historical financial and related info
- Income statements by line of business, balance sheets
- Key ratios and trends
- Historical loss development patterns and favorable/unfavorable run-off of prior reserves
- Detailed expense categorization, large payments
- Each asset, each asset transaction
- Each reinsurer, amount and type of reinsurance ceded, status of recovery, collateral
- Affiliate and subsidiary detail

US General Insurance Companies Must Submit a Formal Actuarial Opinion Regarding Loss Reserves

- Scope of the Actuarial Opinion (and supplemental statements):
  - Reasonableness of balance sheet provision for unpaid and unreported claims
    - Before and after reinsurance
  - Actuarial range
  - Sources of uncertainty and risk
- Actuarial Opinion may be prepared by staff actuary or by outside consulting actuary

US Regulators Closely Scrutinize General Insurance Company Financial Disclosures

Goals

- Identify potential adverse financial indicators
- Evaluate and understand company condition and problems
- Develop appropriate corrective action plans
- Minimize the number and impact of insolvencies

Tools

- Financial analysis and diagnostics
- Risk-based capital
- Financial examinations
- Supervisory plan development

Depth of analysis varies with financial strength, prospective risks and complexity of insurance company

The US Risk-Based Capital Process for General Insurance Companies has Two Main Elements

Calculation of Risk-Based Capital

Triggers for pre-authorized actions

US Risk-Based Capital Calculation for General Insurance

Risk elements requiring capital

R0	Insurance affiliate investment and (non-derivative) off-balance sheet risk
R1	Invested asset risk – fixed income investments
R2	Invested asset risk – equity investments
R3	Credit risk (non-reinsurance, plus ½ reinsurance credit risk)
R4	Loss reserve risk, plus ½ reinsurance credit risk, plus growth risk
R5	Premium risk, growth risk

Company Action Level RBC

$$= R0 + SQRT\left[(R1)^2 + (R2)^2 + (R3)^2 + (R4)^2 + (R5)^2 \right]$$

Authorized Control Level RBC is set at one-half this amount

Illustrative RBC Capital Charges – General Insurance

Line of Business	R4 Reserve Risk	R5 Premium Risk
Personal Auto Liability	11%	17%
Auto Physical Damage	8	9
Homeowners	13	17
Comm'l Multi-Peril	28	10
Workers Compensation	10	14
Other Liability	29	12
Reinsurance – Liability	48	45
AVERAGE	20%	16%

Note: Standard capital charges (as shown) are customized for company-specific experience using a prescribed formula

Illustrative RBC Charges – General Insurance

Investment class	R1 Bonds	R2 Equities
US Federal Government	0.0%	
NAIC Class 1 – Highest quality	0.3	
NAIC Class 2	1.0	
NAIC Class 3 – Medium quality	2.0	
NAIC Class 4 – Low quality	4.5	
NAIC Class 5 – Lower quality	10.0	
NAIC Class 6 – In or near default	30.0	
Common stocks		15.0%

The US RBC Process Includes Pre-defined Triggers and Pre-authorized Actions

	Trigger: Ratio of Actual (adj) Capital to ACL Risk-Based Capital	Pre-authorized Action
No Action	200% or more	None
Company Action Level	150% to 200%	Insurer must submit report: analysis and action plan
Regulatory Action Level	100% to 150%	As above, plus regulatory examinations, analyses, and corrective orders
Authorized Control Level	70% to 100%	Regulator authorized to take control
Mandatory Control Level	Less than 70%	Regulator required to place insurer under control

The RBC Calculation is Part of the Evolving Tool-kit of the US Regulatory Process

- Much more risk-driven than prior regulatory rule-of-thumb ratios
- The product of extensive research and analysis
- But …
  - Cannot respond to all situations
  - May need updating

By design, RBC is a “back-stop” formulaic method to identify potentially failing insurance companies – other regulatory measures are likely to provide earlier identification of companies that may require intervention

US Guaranty Funds Provide a Backstop When an Insurer Insolvency Occurs

- Guaranty Funds pay claimants (within limits) when insurer becomes insolvent
- Financed by taxes and assessments on other insurance companies as needed to supplement the assets of the insolvent insurance company
- Complex, time-consuming and resource-intense process – a last resort
- Not intended to protect the insurance company – designed to protect the interests of the claimants

Coming soon:
ORSA for US General Insurance Companies

ORSA Involves a Self-assessment of The Insurer's Risk Management Framework and Solvency Position

- ORSA is a process that examines the full scope of the insurer's enterprise risk management framework
- The "own" in ORSA places the onus on management — to self assess the risk and capital management framework, given current and future risks
- The ORSA output is a set of documents that demonstrate the results of management's self-assessment

Enterprise Risk Management Framework

The ORSA Results in a Richer View of the Insurance Group's Capital and Risk Management Framework

Risk-based Capital:

- Legal entity
- Rear view
- Factor-based
- Standard
- Regulatory action

Richer View:

- ERM framework
- Governance
- Capital
- Risk
- Feedback loop

ORSA:

- Insurance group
- Forward-looking
- Dynamic factors
- Tailored
- Strategic action

The ORSA improves the regulator's view of risk and capital

- Risk-based capital will remain as the key determinant for minimum legal-entity regulatory capital
- The ORSA will provide the regulator with the insurer's view of its group risk capital and risk management based on proprietary factors and analysis
- The combination of the two will allow regulators to key in and focus on the most important issues for policyholder protection/security

It is Important to Differentiate Between The ORSA as an Internal Process and as an External Reporting Requirement

What an ORSA is	What an ORSA is not
• A continuous process	• A point-in-time activity
• Determined by firm (i.e., “own”)	• Pre-defined by regulator
• Own risk profile and risk appetite	• A regulatory report, a template or form to complete
• Short- and long-term risks	• Just a mathematical calculation
• Both qualitative and quantitative	• A requirement to develop an economic capital model
• Overall solvency needs	• A new group capital requirement
• Over business planning period	• Just a process to tick a regulatory box
• Adequacy of capital	
• Continuous compliance	

An ORSA Pilot will take place In 2012; in 2014 Insurers Subject to The ORSA will File a Summary Report

2011

Guidance Manual Adopted

Active back-and-forth between the NAIC, regulators and industry on ORSA requirements

2012

ORSA Pilot Conducted

ORSA pilot conducted for ten to fifteen insurance groups

Training provided to regulators on enterprise risk and capital assessment techniques

2013

ORSA Industry Roll-Out

Preparation and dry-run of the ORSA process at companies

2014

ORSA Process Refinements

Full implementation and refinements to ORSA approach based on two years of ORSA review experience

Companies file ORSA Summary Report with lead state regulator

Insurers Will Complete an Annual “Self-assessment”; the Regulator May (or May Not) Request a Summary Report

U.S. ORSA — Regulatory Reporting Requirement	
Threshold	• All individual insurers with gross premium > $500M • All insurance groups with gross premium > $1B • Includes unaffiliated domestic and international premium
Annual	• ORSA should be conducted at least annually • Summary report may be requested by the state regulator
Dynamic	• ORSA should reflect changes in business strategy • A refresh may be needed for significant shifts, e.g., M&A
Capital Projection	• Should be consistent with business planning horizon • Suggests capital projections of two to five years
Documentation	• Supporting documentation should be in place • May be reviewed as part of the on-site financial exam

The Summary Report Should Contain Information in Three Sections

Section 1:

Description of Risk Management Framework

- A high-level summary of the insurer's risk management framework

Section 2:

Assessment of Risk Exposures (Quantitative and Qualitative)

- Detail showing the insurer's process for assessing risks, including stress tests

Section 3:

Group Risk Capital and Prospective Solvency Assessment

- Demonstration that current and future capital is sufficient to support risks identified

Description of the Insurer's Risk Management Framework

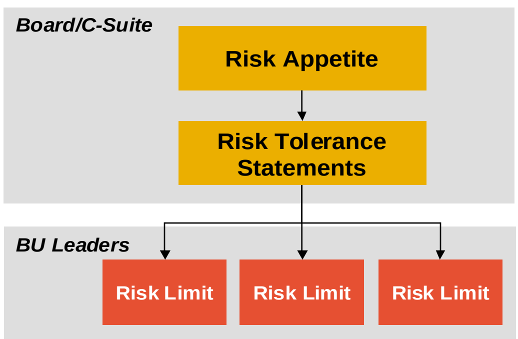
- Summary of the following elements:
  - Risk Culture and Governance
  - Risk Identification and Prioritization
  - Risk Appetite, Tolerances, and Limits
  - Risk Management and Controls
  - Risk Reporting and Communication
- Demonstration that the process is dynamic
  - Ongoing management, monitoring and feedback loops

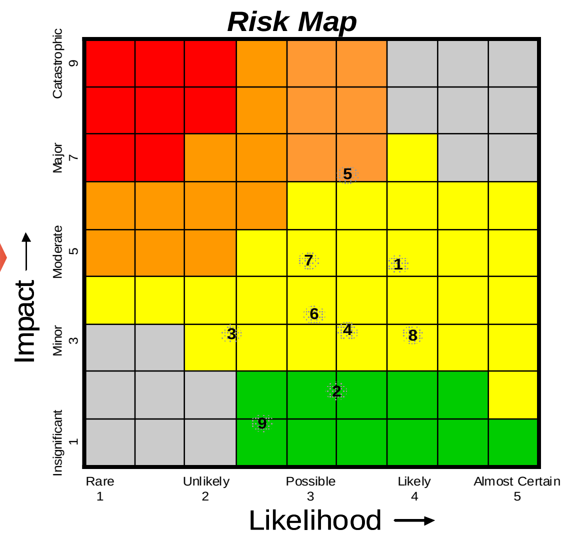
Supporting Risk Policies

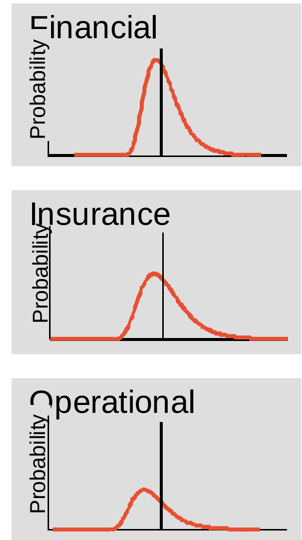
- Underwriting
- Investment
- Claims underwriting/processing
- Asset-liability management (ALM)
- Reinsurance counterparty
- Mergers and acquisitions
- Compensation and incentives
- Anti-fraud
- All other ERM activities, policies or programs

Section 2

Insurer's Assessment of Risk Exposures



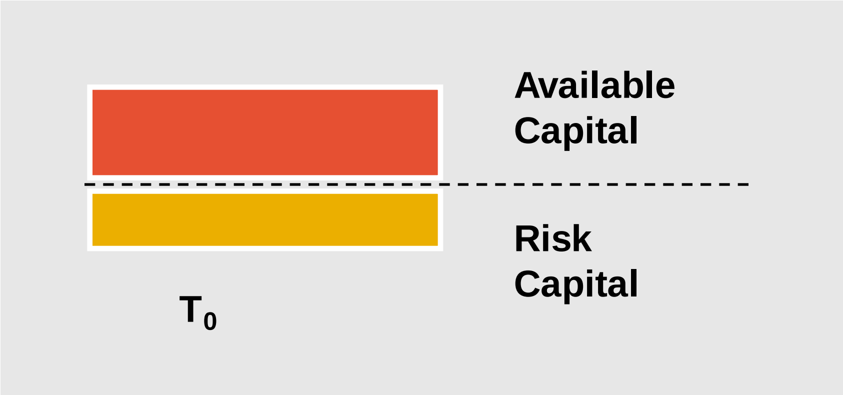




Assess	• Summary of assessment for each material and relevant risk
Method	• May be quantitative or qualitative, depending on the nature of the risk
Stress	• Impact of risk should be shown in both normal and stressed conditions
Capital	• May use regulatory, economic, rating agency or other views of capital
Validation	• Should explain the process for model validation and calibration

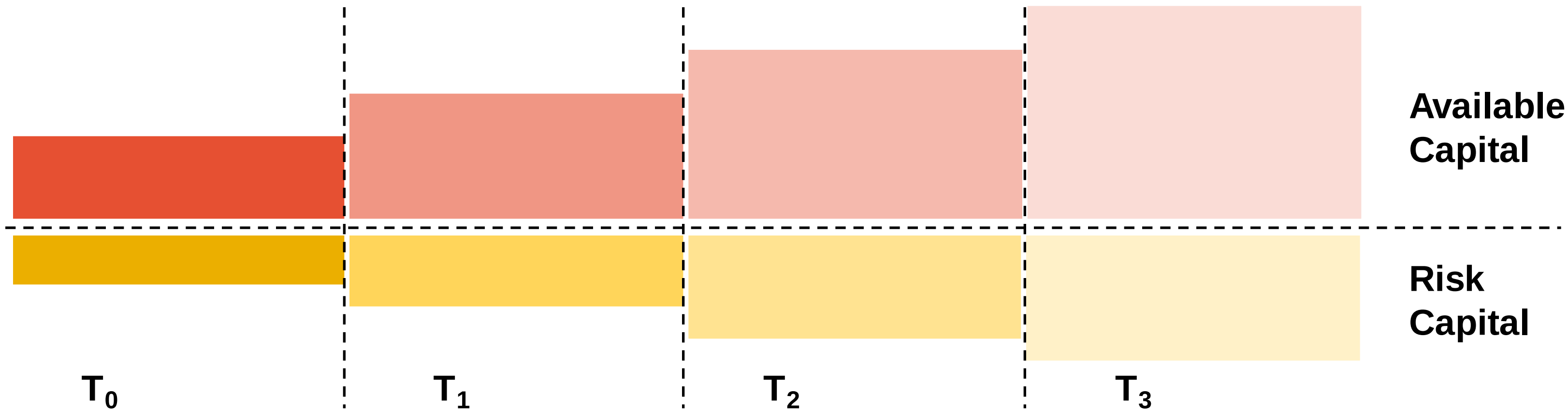
Section 3

Group Risk Capital and…



- Group Risk Capital
  - *Should address the question: What level of capital is necessary to support the group's individual and collective risks at the insurer's defined solvency standard?*
  - *Risk capital: Amount of capital that satisfies the insurer's capital needs at the defined level of security*
  - *Available capital: Amount of "excess" (or "deficit") capital above (or below) the risk capital indication*

Prospective Solvency Assessment



- Prospective Solvency Assessment
  - 2 – 5 year look forward
  - Demonstrate and document link between business strategy and the amount, quality, and source of capital needed to support business strategy
  - Describe actions to address capital shortages or business strategy changes

Rating agencies and solvency assessments

Rating Agencies Also Assess Insurance Company Strength

- Combination of quantitative and qualitative considerations
- Quantitative approaches resemble RBC …
  - But calibrated at a higher level to evaluate strength, not near-failure
  - May include more forward-looking perspectives
  - Earnings strength
- Catastrophe scenarios
- Comparisons to peer companies
- Quality of management

Rating agency evaluations are not part of the regulatory system, but have a significant influence in the marketplace because agents and policyholders want strong insurance companies

Closing observations

US Regulators Use a Multi-dimensional Approach to Solvency Assessment

- Extensive, transparent, standardized public disclosure of detailed financial information
- Regulatory monitoring and analysis of financial data and disclosures
- Regulatory examination of insurance companies
- Risk-Based Capital calculations
- ORSA

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