

SOLVENCY MODERNIZATION INITIATIVE

AN NAIC ISSUES BRIEF

The Issue: What is the Solvency Modernization Initiative?

Overview: The NAIC's Solvency Modernization Initiative (SMI) began in June 2008. The SMI is a critical self-examination of 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. While the U.S. insurance solvency regulation is updated on a continuous basis, the SMI will focus on five key solvency areas: capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues.

The workplan of the SMI includes the following:

- articulation of the U.S. solvency framework and principles,
- study of other sectors' and other countries' solvency and accounting initiatives and the tools that are used and proposed,
- improved tools for risk-focused examinations,
- creation of a new reinsurance regulatory framework,
- movement to principles-based reserving for life insurance products,
- consideration of possible change to group supervisory methods, and
- implementation of new ideas to incorporate into the U.S. solvency system.

NAIC Position:

The Solvency Modernization Initiative Task Force adopted some ideas for consideration in the SMI that include the following:

Framework, Principles, and Roadmap

The SMI will include articulation of the U.S. solvency framework and key principles in one cohesive document to convey foundational concepts underlying the U.S. regulatory system and their interrelationships. The key principles would serve as a basis for further dialogue with other jurisdictions and institutions and allow for a comparison of U.S. solvency principles with solvency principles from other regimes. The principles would also provide a foundation from which to establish goals, priorities and long-term modernization plans for a more robust U.S. solvency regulation framework.

Study of Other Solvency and Accounting Initiatives

The SMI includes analysis of other financial supervisory modernization initiatives, to the extent appropriate. Analysis includes the following:

- the Basel II international capital framework for banks and implementation in the U.S.;
- solvency work by the International Association of Insurance Supervisors (IAIS);
- solvency proposals in place or under development in other jurisdictions, including Australia, Bermuda, Canada, Switzerland and the EU; and

- accounting standards being developed by the International Accounting Standards Board (IASB).

SMI Ideas that Merit Consideration

U.S. regulators are currently studying issues relating to the uses of economic capital, enterprise risk management, and more extensive internal models (with appropriate approvals and safeguards) in the Risk-Based Capital (RBC) system. RBC will be evaluated to determine how to incorporate risks that are not currently included in the RBC calculation as well as issues related to re-calibration. There are numerous group issues under consideration including modification to the current Insurance Holding Company System Regulatory Act, discussion of non-regulated and federally-regulated entities within a group, continued implementation of group supervisory colleges, and discussion of potential group capital requirements. Other ideas encompass reinsurance, insurance valuation, corporate governance, systemic risk, and accounting.

Background:

In the early 1990s, the NAIC's Solvency Policing Agenda resulted in a number of major changes to financial regulation. Risk-based capital requirements and the use of a detailed risk-based formula, as maintained by the NAIC, were adopted into state insurance laws by all states. Statutory accounting principles (SAP) were codified into a comprehensive guide (called "The Accounting Practices and Procedures Manual"). A centralized financial analysis unit (called the "Financial Analysis Working Group") was formed to perform comprehensive analysis on nationally significant insurers which were identified as potentially troubled. Extensive financial solvency tools (FAST system) and automated analytical routines (I-Site) were created for regulatory use.

Regulators have continued to modify the system over the past 20 years, which has resulted in many improvements. The RBC formula now includes stochastic modeling and trend tests. SAP has been updated annually. The NAIC adopted best practices from Sarbanes-Oxley in the form of changes to the Model Audit Rule, which will become effective in 2010. The NAIC also adopted an enhanced risk-focused approach to examinations which incorporates new risk assessments in the areas of governance, ERM and other types of prospective risk, also effective in 2010.

In light of today's national and global developments, we are responding to the call for a comprehensive review of our solvency and regulatory framework.