

NAMIC ISSUE ANALYSIS



GROUP CAPITAL AND U.S. INSURANCE REGULATION

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NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC members represent 40 percent of the total property/casualty insurance market, serve more than 170 million policyholders, and write more than \$253 billion in annual premiums.

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INTRODUCTION

Group capital has become an important feature of the international regulatory space since the 2008 financial crisis. AIG's troubles evolved out of problems within one of its affiliate companies that did not sell insurance and was not located in the U.S. As a result, the international insurance standard setting agency, the International Association of Insurance Supervisors (IAIS) has been pressured by the G-20 finance ministers and the Financial Stability Board (FSB) to create an insurance group capital requirement that will apply consistently around the world. Their view is that such a group capital requirement, applicable to non-insurance entities in the group, would have helped highlight the AIG problems for insurance supervisors before things got out of hand.

A better understanding of why the U.S. insurance regulators and industry cannot agree to an EU-type capital requirement like the current version of the IAIS Global Insurance Capital Standard (ICS) may provide some context for meaningful discussions at the G20, the FSB, Congress, and among other policymakers before such a standard is adopted. In this paper, NAMIC provides background about the U.S. insurance supervisory system and group capital efforts at the IAIS, National Association of Insurance Commissioners (NAIC), and Federal Reserve to outline the real need for a directional change at the IAIS.

Several issues have arisen in the quest for an international group capital standard that reveal the need for flexibility in the calculation of the standard, especially in the U.S.

- The U.S. focuses regulatory attention on individual legal entities that write insurance to protect the policyholders who buy insurance from those entities. These entities are scrutinized to ensure they are adequately capitalized. U.S. supervisors argue the best way to derive a group capital calculation is to add the various entities' capital requirements so there is a clear view into both the legal entities that are part of the group and the whole insurance group.
- Rate/pricing regulation in the United States has a distinct impact on property/casualty insurance companies. The regulatory control over insurance pricing limits the ability of U.S. insurers, especially mutual insurance companies, to immediately raise the funds to meet higher capital requirements. Most other countries do not have the same stringency around rate regulation.
- State insurance departments have multiple tools to evaluate the solvency of insurance groups and do not rely exclusively on capital requirements. Many of these tools are not incorporated into the regulatory systems of other countries. U.S. stakeholders believe that a flexible approach focused on the outcomes of the regulatory system is the best international standard.
- The U.S. regulatory system does not support propping up poorly managed companies with high capital requirements. Instead, the focus is on protecting policyholders, not investors, and letting poorly managed companies fail.

These differences in regulatory approach have created challenges in reaching consensus at the IAIS. U.S. stakeholders have asked for flexibility, not a requirement that other countries use the same approach as the U.S. The U.S. strongly prefers a bottom-up aggregated approach that combines all legal entity capital requirements within a group and removes redundancies, instead of the top-down consolidated approach pursued at the IAIS. The U.S. needs are reasonable and yet they have not been fairly evaluated by the IAIS. Any agreement on a global ICS will be detrimental to U.S. insurance groups and their policyholders as long as the IAIS is unwilling to add the flexibility required by U.S. regulators and insurance groups; if it is unwilling to accept the comparable outcomes of U.S. solvency regulation; and if it is unwilling to recognize the primacy of focusing on policyholder protection over investor/creditor protection. This is an unacceptable potential result.

EXISTING U.S. INSURANCE CAPITAL REQUIREMENTS

In the U.S., there is a risk-based capital (RBC) requirement developed by the NAIC for all insurance underwriting companies on a legal-entity basis. This requirement includes capital charges for non-insurance entities that are affiliates under the insurance company but does not include entities that are above the underwriting entities in the corporate structure or are part of a different segment of the parent organization. For property/casualty insurance companies it also includes capital charges for assets, credit, premiums, reserves, catastrophes, and operational risks. In the RBC, calculation factors and covariance are used to appropriately weight the risks of each category.

Mutual insurance companies cannot be owned by any other entity since they are owned by their policyholders. There cannot be any other parent or ultimate company over a mutual insurance company. There can be affiliates under a mutual company, but all of these affiliates are stock-based entities held in part or in whole by the mutual insurance company. Consequently, for mutual insurers that write insurance policies in their top-tier company, their RBC requirement already provides a complete group capital calculation. Currently the RBC calculation does not include a complete capital picture for insurance groups held as part of a conglomerate or by a non-insurance holding company that does not write insurance policies. The insurance companies at AIG were held by one of these conglomerates. As a result, the NAIC began discussion after the financial crisis about a group capital calculation and other supervisory tools that would address these issues. Due to the legal-entity supervisory focus in the U.S. and the value of maintaining a view into the risk of each legal entity, the NAIC group capital calculation efforts have properly focused on adding or “aggregating” legal-entity capital requirements in an accurate and risk-sensitive manner. Using a consolidated approach as is applied in the ICS could obfuscate valuable information about potential problems of individual legal entities.



THE IMPACT OF THE U.S. LEGAL ENTITY APPROACH ON CALCULATING CAPITAL

The U.S. approach to insurance company supervision has always been focused on the individual legal entities from legal, accounting, and capital standpoints. Since insurance contracts are written by insurance legal entities and not insurance groups and since the focus of U.S. regulation is the protection of the policyholders, the U.S. has always believed that capital must be held at the level of the company that is writing the insurance policy to protect those customers entering into a contract with that company, not at the level of the insurance group. The legal entity is the only corporate organization that can be held legally responsible for the claims of policyholders. A view of the insurance group is useful, but since regulators cannot require one legal entity to move capital to another within the group without impacting the rights of the policyholders, it has not been – and should not be – the priority of U.S. regulation.

Since ultimately the buck stops with the legal entity, the regulatory accounting system used by all insurance companies doing business in the U.S. – designed and controlled by the NAIC and referred to as statutory accounting – focuses on the entities that underwrite insurance and enter into insurance policies/contracts with policyholders. Statutory accounting is more conservative than U.S. Generally Accepted Accounting Principles (GAAP) to better protect policyholders, and it is more appropriate for insurance as it is tailored to address the unique needs of an insurance accounting system. Statutory accounting does not include consolidation across the entire insurance group to avoid obfuscating any problem that might arise within specific legal entities. On the other hand, most of Europe and Asia apply consolidated accounting. In the U.S. all individual insurance companies file statutory quarterly and annual financial statements. Only public companies file consolidated U.S. GAAP annual statements.

The assets and liabilities reflected in the statutory accounting financial statements are used to calculate the RBC requirements for the legal entities writing the insurance policies. As previously mentioned, if the ultimate controlling parent of an insurance group directly writes insurance policies and directly complies with RBC requirements, then that legal entity's capital requirements will already include capital charges for all the other companies under that parent. Such a company is currently subject to a full group capital requirement. This is the case with most mutual insurance companies.

Since GAAP financial statements are not available for mutual and private insurance companies, even the Federal Reserve is required to accept statutory accounting for capital and other financial calculations for the mutual insurers they regulate, pursuant to the Insurance Capital Standards Clarification Act of 2014. Requiring mutual and private companies to switch to a new accounting standard would be disruptive, inefficient, and lack the value of an aggregated approach. For these reasons, both the Federal Reserve and the state insurance departments are working together toward an aggregated approach to capital calculation for U.S. insurance groups.

Any international capital standard that would require U.S. companies to convert to a new accounting standard or ignore the corporate laws of the 50 states would be unreasonable for those companies and would further contribute to an unlevel playing field for U.S. insurers.

THE IMPACT OF U.S. RATE REGULATION ON CAPITAL

When the McCarran-Ferguson Act was enacted to provide a limited exemption from U.S. federal antitrust laws, the trade-off was that the states would enforce their own laws such as rate regulation to protect against monopolistic behavior by insurers. The reason for an exemption from federal antitrust laws was to enable companies to share combined loss data and use rating agencies, like Insurance Services Organization, National Council on Compensation Insurance, and others, to provide a valid rating structure. If shared data had not been available, small insurers would never have been able to compete with large

insurers, and the industry would have evolved into an oligopoly of a few large companies. The exemption from federal antitrust laws was created to protect competition in the insurance industry.

Rate regulation exists in different forms in different states, but all laws follow the standard that rates cannot be excessive, inadequate, or unfairly discriminatory. These rate standards have been interpreted to require that all rate structures are actuarially justified and each legal entity can only have a single rate structure. This means that a U.S. property/casualty insurer must not charge different rates for similarly situated policyholders to avoid unfair discrimination and cannot charge more or less than is actuarially justified to avoid excessive or inadequate rates. If insurance groups want to experiment with a new rate structure, they can only do so through a different insurance legal entity. In other countries there is flexibility within a single company to set up business units with different rate structures. Companies in those countries are also often able to charge whatever the market will bear, as the regulatory rate review is primarily concerned about solvency. So, by increasing their prices these companies can increase their surplus and, therefore, their capital level. U.S. rate regulation can limit a company's ability to increase the level of capital it holds in the short run. Companies are not able to raise rates just to increase their capital level if such increase is not actuarially justified. The only way for mutual property/casualty insurers to raise capital is through retained earnings or the issuance of surplus notes.

This difference in the rating laws in the U.S. and the consequent limits on increasing capital create an unlevel playing field for U.S. insurance groups if an inflexible ICS is used in countries without similar regulation of insurance rates.

U.S. REGULATORS APPROACH TO GROUP SUPERVISION AND SOLVENCY

U.S. state insurance regulators are highly focused on solvency and market regulation. They must balance the two to ensure the insurance industry they regulate continues to be strong, secure, and stable while delivering the products and services to consumers in compliance with the laws. To meet these objectives, state insurance regulators have a significantly hands-on solvency supervisory system. All states must enact certain NAIC model laws regulating solvency to assure consistent regulation throughout the country. States failing to include specified accreditation requirements will lose certain privileges, and this loss will negatively impact insurance companies domiciled in their state. Accreditation requirements include:

- Annual and quarterly financial reporting pursuant to statutory accounting principles;
- Regular comprehensive financial examinations;
- Annual corporate governance disclosures;
- Annual enterprise risk reporting (ORSA and Enterprise Risk Reports);
- Numerous holding company reports and approvals (including validating reinsurance protection, itemizing mergers and acquisitions, approving intracompany transactions, approving extraordinary dividends, etc.);
- On-going company/group financial analysis;
- Restrictions on investments for inclusion as admitted assets;
- Monitoring of solvency ratios;
- Authority to intervene with companies in hazardous financial condition exhibited by activities other than capital weakness; and
- RBC reporting and compliance, including charges for affiliate risk, investment risk, asset risk, credit risk, market risk, underwriting/premium/reserve risk, modeled catastrophe risk, operational risk, and working on a group capital calculation as well as ladders of supervisory intervention for diminishing RBC levels below 300 percent of the RBC minimum requirement.

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At the same time, U.S. state regulators are also heavily engaged in market conduct regulation to ensure consumer protection. The insurance code in all states includes authority over numerous market practices beyond rate regulation, such as underwriting, claims, and marketing practices. In addition, state laws provide regulatory authority to review and approve policy language, required provisions in all policies, and mandatory offers of certain coverages by all insurers writing some lines of insurance. There are no required model laws to address these market regulation subjects, but in addition to rate regulation, all states include laws addressing the following issues:

- Underwriting issues like restrictions and notice requirements for cancellation, nonrenewal, and declination decisions; mandatory offers of coverage and restrictions on underwriting decisions;
- Claims issues such as unfair claims practices, notice and timing requirements for investigation, payment, reservation of rights, appeal processes, and bad-faith claim handling;
- Advertising and marketing requirements including truth in advertising, anti-rebate laws, licensing of producers among others;
- Policy form approval requirements authorizing regulatory review and approval of language used in insurance policies, required language, requirements for readability of language, restrictions on use of clauses, etc.;
- Periodic and targeted market conduct examinations to assure compliance with all market regulations; and
- Customer complaint process for addressing any issue with any insurance company.

Most of the other countries active at the IAIS do not have laws requiring supervisors to perform all of these functions. The U.S. regulatory system is much more focused on evaluating and regulating the day-to-day activities of insurance companies than on specific levels of capital held. A U.S. regulator would detect problems within a company because of this solvency and market-based scrutiny long before its capital levels would reflect problems. U.S. regulators understand that in the event of unexpected catastrophe or global financial crisis, no amount of capital can protect insurers or their policyholders. Only high levels of oversight can keep the regulator informed of the trouble an insurer may be experiencing. A high capital requirement does not compare with the high level of oversight U.S. regulators have over U.S. property/casualty insurance companies. While this intense oversight may not be preferred by the companies in the U.S., it is the system they have, and it is based on principles of insurance regulation in the U.S. that go well beyond capital requirements.

Any international group capital requirement that would not consider all the other supervisory tools available as well as data collected in the U.S. and the costs incurred by U.S. companies in complying with these regulatory requirements would create an unlevel playing field. This is why an outcome-based approach with flexibility in the process is very important to U.S. insurers and regulators.



PROTECTION OF POLICYHOLDERS AND GUARANTY ASSOCIATIONS

The primary focus of U.S. regulation of insurance is on the protection of policyholders. Rate regulation, the focus on legal entities, even solvency and market conduct regulation are all about protecting insurance consumers in the event an insurer cannot or does not meet its legal obligations to its customers. The insurance regulatory focus is not on protecting creditors or investors. Even after a company has been declared insolvent, the needs of the insurance policyholders are top of mind for regulators. The solvency system does what can be done to prevent insolvencies and to help companies that need rehabilitation or can be sold to other solvent companies, but the U.S. allows companies to fail that should fail. The U.S. regulatory system does not prop up companies with poor or criminal management. Nonetheless, policyholders are not forgotten. The U.S. has guaranty fund associations that provide basic coverage to policyholders if any insurance company goes insolvent. Most other countries that are members of the IAIS do not have this feature in their regulatory environment for ultimate policyholder protection. In the U.S. insurance companies are responsible to pay assessments to the guaranty funds in each state where they do business to ensure payment of policyholder claims of insolvent companies. This is part of the cost of doing business and part of a process that makes the strength of solvency regulation important to all companies in each state.

The U.S. guaranty fund system is created by statute in every state and includes life, health, and property/casualty insurance associations in most states. It is a condition of doing business in the state for all companies to be members and contribute to the guaranty association. The coverage for policyholders of insolvent insurance companies is completely funded by the remaining assets of the insolvent company and assessments of the remaining solvent insurance companies doing business in the state. Solvent companies are assessed based on their market share within the state for the deficits the guaranty association incurred that were not covered by the remaining assets of the insolvent company. Most states limit these assessments on an annual basis to 1 percent to 2 percent of the premium written in the state. There is no state funding of these organizations.

CREATING A U.S. GROUP CAPITAL CALCULATION

Internationally U.S. stakeholders – including state regulators, federal agencies, and the insurance industry – have pushed for a flexible requirement that will consider the style of supervision in the U.S. and the ways it varies from supervisory systems in other countries. Team USA – the moniker given to the collective group of U.S. representatives involved in international insurance negotiations – has not sought equivalent requirements from other countries. Instead, U.S. stakeholders have sought to achieve mutual recognition of different approaches and flexibility in the international standards to focus more on the outcomes of insurance supervision. Recently Team USA has been granted the right to compare its own approach that aggregates legal entities' capital requirements to the consolidated system of group capital that is used in the current version of the ICS. This requires that the NAIC complete the process of creating an aggregated approach to group capital, which it is calling the Group Capital Calculation (GCC). The Federal Reserve is also working on an aggregation and calibration capital requirement that is intended to align with the NAIC's GCC.

Neither the NAIC nor the Fed's group capital approach has been finalized. They are both working through the process methodically and carefully to create a useful approach that will be appropriate for the U.S. insurance market, insurance consumers, and system of insurance regulation. However, there are artificial time constraints at play internationally that require expedited development. The 2018 Covered Agreement between the EU and the U.S. requires an adopted GCC by 2023 or the U.S. will be in breach of the Covered Agreement. Five years may seem an adequate time frame for completion, however, it is a very aggressive goal considering the time required to develop a new model law, add the law as an accreditation requirement, and pass that law in all states.

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Further international pressure comes from the recent Kuala Lumpur Agreement entered into by the U.S. and other members of the IAIS executive committee. This agreement requires a final GCC to be field-tested between 2020 and 2024 to make it eligible for comparison with the reference ICS in 2025. The U.S. needs to be prepared with a reasonable GCC draft that can be field-tested by 2020 to meet these obligations. This is a much shorter timeline that requires immediate action.

The Kuala Lumpur Agreement was entered into by members of the IAIS Executive Committee at the IAIS annual meeting in 2017. It provided significantly more time for the IAIS to resolve its differences by creating a five-year monitoring period during which internationally active insurance groups would have to annually and confidentially file the latest version of the ICS using a market adjusted valuation (MAV) system. In addition, at the discretion of the jurisdictional supervisor, the agreement provided for optional filings of the ICS using a GAAP system, which is preferred by the Federal Reserve and U.S. stock companies, or a filing using internal capital models, a completely different capital approach used in Europe allowing companies to use approved capital models instead of the standard model for Solvency II. At the end of the monitoring period the IAIS would look at the data under the various approaches to determine what to do with the capital model thereafter. In addition, and somehow separate from the alternative filings under the ICS, the Executive Committee agreed to look at data from the U.S. using an aggregated approach to group capital instead of the consolidated approach used in the ICS under the MAV, GAAP, and internal model versions. That aggregated approach will be evaluated to see if it produced comparable outcomes to the ICS at the end of the monitoring period.

The NAIC has issued a series of exposures that seek input on specific questions exploring how the GCC should differ from RBC. It is working on determining the scope of the group to which the calculation should apply – the full insurance and financial group with all entities under them or the full enterprise including affiliates and subsidiaries outside and unrelated to the insurance and financial group. The NAIC is also working on deciding to which insurance groups the calculation will apply – all holding companies, only those of a certain size, or those with international activities, which is all the IAIS technically requests. The GCC is not supposed to be a “required” amount of capital – just a calculation of the amount of aggregated capital that is available – but it is not known which insurance groups will be expected to complete the calculation for their group supervisors. Most importantly, the industry has not seen the final calculation. The working group’s goal is to be ready for beta testing/field testing of a formula before the end of 2018. If the field testing in 2019 reaches conclusion so a formal calculation can be compared to the reference ICS that is to be completed in 2019, then the U.S. will be on target for proving that its system can produce comparable outcomes to the ICS. However, the IAIS must still be persuaded that the entire solvency approach should be the subject of comparison, not just the numbers reached under the group capital calculation. That is the next battle on the horizon.



CONCLUSION

The direction of the IAIS ICS discussions and the unwillingness for flexibility internationally need to be addressed. If no directional changes are made at the IAIS, the ICS will put the U.S. insurance industry and its policyholders at a major disadvantage. If some version of the current ICS is implemented as a formal IAIS standard:

- The U.S. insurance marketplace could be disadvantaged because of rate regulation and the impact on property/casualty insurers' ability to raise capital.
- Consumers could be disadvantaged because of the IAIS insistence on a consolidated group capital requirement, ignoring the U.S. capital system that is based on a more granular legal-entity approach requiring an aggregated standard.
- The U.S. industry could be disadvantaged if new and inconsistent group capital and group supervision requirements arise out of the IAIS adding to the already significant solvency system at the state level.

NAMIC has been and will continue to work to protect against these consequences at the IAIS, the Financial Stability Board (FSB), the U.S. Congress, the NAIC, and in the individual states. The IAIS must make appropriate policy decisions that respect jurisdictional differences and accommodate U.S. solvency regulation and capital requirements of U.S. insurance groups. If it fails to do so on its own, the IAIS must be re-directed in its mission, possibly by the FSB or the G20 finance ministers. All stakeholders in the U.S. whether regulator or insurance industry should join in a message to strongly urge that the IAIS change course or be re-directed to include flexibility in its ICS proposal. Ultimately, if all U.S. stakeholders come together to deliver a message to the IAIS and the FSB that the U.S. industry will not agree to the ICS approach without built-in flexibility, there is a chance to force a needed course correction. If this effort fails, the entire IAIS workstream to create a global ICS for insurance groups must also fail. Any other result would damage the global insurance market in general and the U.S. insurance groups in that market, in particular.

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