NAMIC ISSUE ANALYSIS

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ADVOCACY

THE NEXT ITERATION OF HOLDING COMPANY REGULATION –

WHAT DOES IT LOOK LIKE AND WHAT SHOULD BE DIFFERENT?

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TABLE OF CONTENTS

INTRODUCTION

Since the global financial crisis state insurance regulators have been keenly focused on modernizing the U.S. system of solvency regulation, undertaking and implementing major initiatives impacting insurers of all sizes. Those include enhancing insurance holding company supervision, developing group-wide oversight capabilities, and creating regulatory tools and expansive disclosures designed in part to target non-insurance entity risk. While the National Association of Insurance Commissioners has been the driving force behind many of these initiatives, international pressure from institutions such as the Financial Stability Board, the International Association of Insurance Supervisors, and the International Monetary Fund have also influenced the thinking and direction taken in the U.S. More recently, the covered agreements between the U.S. and the European Union and the United Kingdom have added a new motivation for the NAIC to amend its model laws to comport with each of these agreements.[1]

The chief target for many of these initiatives are large, complex insurance holding company systems, recognizing that insurance entities could be exposed to material risk from non-insurance affiliates. Something often repeated in the insurance regulatory community since the crisis were the troubles faced by AIG, most notably the problems within one of its affiliate companies that did not sell insurance. U.S. insurance regulators have voiced concerns that they lack the necessary authority to oversee and intervene when activities of non-insurance affiliates within an insurance holding company system might pose material risks to an insurer, and many of these regulatory responses were designed to respond to this need. Unfortunately, an important element that decision-makers have often overlooked is the notion of tailoring these regulatory tools to the size and complexity of the insurance group. Specifically, the Enterprise Risk Report and the impending Group Capital Calculation are tools that need to be tailored based on the activities of the insurance group; however, the ERR is a required filing for all insurance holding companies and, as of this writing, it is still unknown who will be required to file the GCC. For many IHCS, these tools are duplicative and add unnecessary compliance costs to the system.

The purpose of this paper is to examine recent changes to holding company laws and regulations and consider how the new GCC tool fits in with the existing framework. Several practical questions are worth exploring, particularly as the NAIC, and eventually the states, considers what the next iteration of holding company regulation looks like and how size and complexity of the group will be factored into their decision-making. The paper includes a brief summary of recent holding company changes, followed by a review of the breadth of financial and risk information that lead state regulators already receive as part of their solvency oversight duties. Finally, the paper concludes with a discussion about possible alternatives the NAIC should consider to tailor holding company regulation to the size and complexity of the IHCS, including consideration of exemptions and allowing for regulator discretion for requirements such as the ERR and GCC. The intent of these tools is to assist regulators in addressing the systemic risk created by a few very large and complex insurers engaging in non-insurance activities, but regrettably if nothing is done both tools will apply or continue to apply to holding companies of all sizes and complexity, solely for the sake of maintaining uniformity and appeasing international standard setters.

[1] As it relates to the covered agreements signed between the U.S. and the European Union and United Kingdom, any state with U.S. groups operating in either the EU or the U.K. will need to adopt these legislative changes by Nov. 7, 2022, in order to effectuate compliance with the covered agreements.

THE EVOLUTION OF HOLDING COMPANY REGULATION

State insurance regulators started to explore holding company regulation in 1966 due to a perception that holding companies were being formed as a means to circumvent state insurance statutes. The NAIC adopted the Insurance Holding Company System Regulatory Act (#440) and Insurance Holding Company System Model Regulation (#450) in 1969, both of which would eventually become required elements of the NAIC accreditation program. Since the early 1970s state insurance departments have relied on this framework to provide guidance on insurance holding company supervision, although there have been several substantial amendments to the models over the years and more changes are being considered. The most recent changes were adopted in 2014, but there were also significant amendments in 2010 and 2001 that likewise expanded the authority of state insurance regulators over an Insurance Holding Company System.

The changes to the models in 2001, 2010, and 2014 were all prompted by external forces and came after much deliberation and study by regulators and the industry. Each subsequent change moved holding company regulation away from the traditional legal entity approach toward a group solvency approach to regulation. The 2001 amendments were the result of a review to assess the impact of the federal Gramm-Leach-Bliley Act of 1999. The amendments updated the time frames under which a state must consider a proposed acquisition of a domestic insurer by a financial holding company. The 2010 amendments, which ushered in new enterprise risk disclosures and greater examination authority, came on the heels of the financial crisis and were borne out of the NAIC's 2008 Solvency Modernization Initiative[2], a self-assessment of the state solvency system focusing on enhancing group supervision. Concluding factors from the assessment listed enterprise risk identification, management, and reporting as key elements missing from holding company regulation. The most recent change to holding company regulation implemented similar group-wide supervisory elements but for internationally active insurance groups, giving state insurance regulators the legal authority to act as a group-wide supervisor for such companies and the ability to request group-level information and assess the enterprise risks affecting the group, among other things.

The NAIC has been developing the Group Capital Calculation since late 2015, in part to build off the amendments adopted in 2010, but also so regulators can better understand an insurance group's financial risk profile and further evolve holding company regulation to a group-wide approach. When adopted, the GCC will aggregate the capital requirements of all the affiliates of an insurance group into a calculation of the group capital held and required by members of the group. The GCC will provide regulators with a methodology to assess the capital positions of all material affiliated business entities, a quantitative exercise to help evaluate such information and monitor trends. Alongside related financial reporting, the GCC also gives state insurance regulators another option and expands their authority to collect specific financial information from all material affiliates. The question becomes whether the GCC will provide regulatory value to all IHCS equally or whether there are other existing alternatives regulators are utilizing to quantify risk at the group level.

[2] The 2008 global financial crisis resulted in various regulatory agencies developing new guidelines and requirements. The NAIC formed the Group Solvency Issues (E) Working Group to consider possible enhancements to U.S. Group Supervision through coordination with the International Association of Insurance Supervisors and the Solvency Modernization Initiative. Key changes to come from SMI include: Enterprise Risk Report (Form F), establishment of supervisory colleges, adoption of Risk Management and Own Risk and Solvency Assessment Model, Corporate Governance Annual Disclosure Model, and revisions to the Annual Financial Reporting Model Regulation to expand the internal audit function to provide reasonable assurance of the effectiveness of enterprise risk management, internal control, and corporate governance.

EXISTING FINANCIAL AND RISK DISCLOSURE REQUIREMENTS

The evolution of holding company regulation has come full circle in the last 10 years as regulators ponder the GCC as a new quantitative regulatory tool to add to the decades-old model law[3]. A closer look at some of the other required financial and risk information already disclosed to or accessible by the lead state regulator of an IHCS can illustrate the breadth of financial and risk information regulators already have access to for review and why there is a need to tailor holding company regulations based on the size and complexity of the operations.

Prior to 2010, the regulatory approach taken to supervising holding companies was to regulate the insurance entities with a focus on monitoring for potential abuses by affiliates. That included requirements for authorization to acquire an insurer, commissioner approval of certain material transactions such as extraordinary dividends or reinsurance agreements, and access to books and records. The 2010 amendments retained these provisions but expanded state regulatory authority giving regulators the power to compel production of books and records and examine the non-insurance entities in a holding company to assess the possibility of solvencies that might lead to systemic risk. Specifically, those provisions read:

> "The commissioner may order any insurer registered under Section 4 to produce such records, books, or other information papers in the possession of the insurer or its affiliates as are reasonably necessary to determine compliance with this Chapter.
>
> The commissioner may order any insurer registered under Section 4 to produce information not in the possession of the insurer if the insurer can obtain access to such information pursuant to contractual relationships, statutory obligations, or other method.
>
> In the event the insurer fails to comply with an order, the commissioner shall have the power to examine the affiliates to obtain the information. The commissioner shall also have the power to issue subpoenas, to administer oath, and to examine under oath any person for purposes of determining compliance with this section."

[3] The ERR was desired by regulators because it represented a more qualitative approach to regulation versus a quantitative approach that focuses on analyses of annual and quarterly financial reports, RBC ratios, IRIS ratios, etc.

The intent is clear: access to non-regulated entity financial information is desired, and the approach taken relies on regulatory discretion for the analysis of company disclosures and the examination of affiliate books and records. In addition to affiliated company books and records, regulators still have access to insurer quarterly and annual financial statements as well as legal entity risk-based capital reports. Access to, and review of, company books and records as well as insurer capital positions bolsters regulatory authority and will continue to provide valuable insight for insurance department financial examiners and analysts.

In addition to access to books and records, and legal entity RBC reports, risk-focused examinations conducted every three to five years with ongoing financial analysis are continually evolving to meet the demands of regulators. For instance, gaining an understanding of the corporate governance structure, including enterprise risk management, has become a noted feature of insurance solvency regulation of late. With the adoption of the Corporate Governance Annual Disclosure Model Act (#305) and Model Regulation (#306), the Risk Management and Own Risk and Solvency Assessment Model Act (#505), and the amendments to the Annual Financial Reporting Model Regulation (#205) – all NAIC accreditation models – the financial examiner and analyst have a considerable amount of new qualitative information to review to aid in the ongoing assessment of the financial solvency of an IHCS. Much of the information disclosed in these required filings, to be discussed in more detail hereafter, effectively make the ERR obsolete for larger IHCS.

Financial examiners and analysts are tasked with reviewing and assessing these new filings. The financial examiner already has a tool to review and assess corporate governance, Exhibit M – Understanding the Corporate Governance Structure. The Financial Condition Examiners Handbook, or "Exam HB," includes regulatory guidance for financial examiners, including Exhibit M. As it relates to ERM specifically, it includes areas of consideration in reviewing the risk management function and provides methods to assess how a company identifies, monitors, evaluates, and responds to risk. Furthermore, it is the role of the financial examiner to provide an assessment of ERM and how it contributes to the overall corporate governance program. For large companies subject to the Own Risk & Solvency Assessment summary report, regulators generally rely on that report for the evaluation of risk management. However, for IHCS that do not submit an ORSA summary report, the guidance encourages examiners to use Exam HB ORSA guidance, as it "may still be a helpful tool for the examiner to consider in assessing the maturity of an insurer's risk-management framework, which should include an assessment of each of five key principles.[4]"

Regulatory review and assessment of an IHCS's corporate governance and ERM framework have been aided by the addition of new disclosures including CGAD and ORSA summary reports. Corporate governance review includes financial examiner guidance to document his or her understanding and assessment of an insurer's board of directors and management. Further, corporate governance review procedures also include guidance to test specific governance controls for their adequacy in managing specific risks. The examiner and analyst are encouraged to use the CGAD to gain a better understanding of the corporate governance structure. As it relates to ERM, regulators are required to evaluate ORSA documentation, including the ORSA summary report and the Form F; however, as discussed later, regulators prefer the ORSA summary report over the Form F in evaluating enterprise risks for companies required to comply with both requirements.

The Annual Financial Reporting Model Regulation (#205), commonly referred to as the Model Audit Rule, was amended in 2010 to add provisions requiring a mandatory attestation statement of internal control by management. This management report is required for all insurance companies exceeding an annual premium threshold and must include a statement on

[4] 2019 NAIC Financial Condition Examiners Handbook Exhibit M: Five Key Principles: 1. Risk Culture and Governance; 2. Risk Identification and Prioritization; 3. Risk Appetite, Tolerances and Limits; 4. Risk Management and Controls; 5. Risk Reporting and Communication.

the effectiveness of internal controls over financial reporting.[5] In addition, the MAR also requires that an audit committee be formed, that external auditors report to that audit committee, and that certain levels of independence within the audit committee exists. Financial examiners are expected to review that insurers are complying with these regulations and factor the results of this review into their ERM assessment and overall assessment of corporate governance.

Finally, holding company system analysis is conducted by the lead state, which is responsible for coordinating all financial exams for the holding company group. The purpose of holding company analysis is to give lead state regulators a top-down view of the holding company that is well understood by regulators given the legal-entity focus of insurance regulation. Holding company analysis is completed by an insurance department financial analyst annually and includes supplemental procedures encompassing the review of transaction-specific holding company forms such as Form A, D, and E, as well as extraordinary dividends/distributions.[6] The Financial Analysis Handbook – like the Exam HB but to provide guidance for financial analysts – is continually updated to incorporate processes and procedures to review and assess requirements from new and updated solvency model laws and regulations, such as the holding company. When group-wide supervision was adopted in 2014, new procedures for analysts were developed, including a Form F review to be done in conjunction with the review of Form B, the annual registration statement. This is done to gain an understanding of the holding company system and to identify and consider affiliated risks within the holding company system.

As illustrated, there is a great amount of financial and risk information that lead state regulators have at their disposal, and there are existing processes and procedures for regulators to use to review and assess this information. The ERR continues to represent a substantial compliance challenge and additional cost for smaller companies, providing very little benefit to insurers or regulators. Further, the ORSA summary report and all the various examination and analysis proceedings have all but made the ERR redundant for large IHCS. The GCC is like the beefed-up version of the ERR, as it also presents significant compliance challenges and will provide little to no additional value beyond what is already gleaned from current regulatory filings for most IHCS. There are many reasons why the next generation of holding company regulations needs to be tailored based on the size and complexity of the holding company, and there are potential solutions the NAIC could consider on this front.

ALTERNATIVE APPROACHES TO CONSIDER IN TAILORING HOLDING COMPANY REGULATION

State insurance regulators have more than enough information and are in the best position to determine if an exemption or an expedited approach to either the ERR or GCC should be considered by the lead state. There is a lot of variability between companies in the insurance industry in terms of size, structure and complexity of operations, types of products offered, and the depth of information already provided to the lead state. Recognizing this reality through provisions in the model law and regulation that exempt certain IHCS and allow for regulator discretion in this area would be prudent and efficient regulation.

Given all the financial and risk information assessable by lead state regulators, the following section discusses some of the issues that can arise when holding company regulation is not tailored to the size and complexity of the holding company.

5 Insurers with direct written and assumed premium of $500 million or more are required to comply.

6 Form A is a statement regarding the acquisition of control of or merger with a domestic insurer; Form D is a prior notice of a transaction statement, and Form E is a pre-acquisition notification form regarding the potential competitive impact of a proposed merger or acquisition by a non-domiciliary insurer doing business in a state or by a domestic insurer.

Included will be an exploration into how size-related exemptions or other alternatives should be considered when drafting revisions to the HCA to avoid overburdening small and less complex insurers with unnecessary compliance costs.

The GCC is the next holding company disclosure insurers will have to learn to prepare, and regulators will have to know how to assess and review. It is widely anticipated that the GCC will become an accreditation standard when it is adopted, representing another major milestone in holding company regulation. Prior to the adoption of the ERR, NAMIC and others in the industry raised many concerns about the disproportionate impact the ERR will have on small companies. Given the similarities between the perceived usefulness of the ERR and GCC, an analysis of the concerns raised by regulators regarding the value derived from ERR filings will be a useful exercise, particularly in light of concerns previously raised by NAMIC and the industry. Given that there are similar industry concerns around the scope of the GCC, there is reason to believe that some of these same regulatory issues will emerge as the GCC is implemented throughout the states.

Some states have been collecting Form F filings since 2013, and most states have been collecting and reviewing the disclosures since before the required Jan. 1, 2016, deadline to maintain NAIC accreditation. That has given regulators time to reflect on the effectiveness of the reporting process and to compare the information provided by groups in the Form F filings versus other regulatory interactions such as the ORSA summary report or financial examination proceedings. The NAIC conducted a survey in mid-2016 when 36 jurisdictions provided critical feedback on issues ranging from the overall effectiveness of Form F reporting to areas that provide the most value and suggestions for deletions or improvements[7].

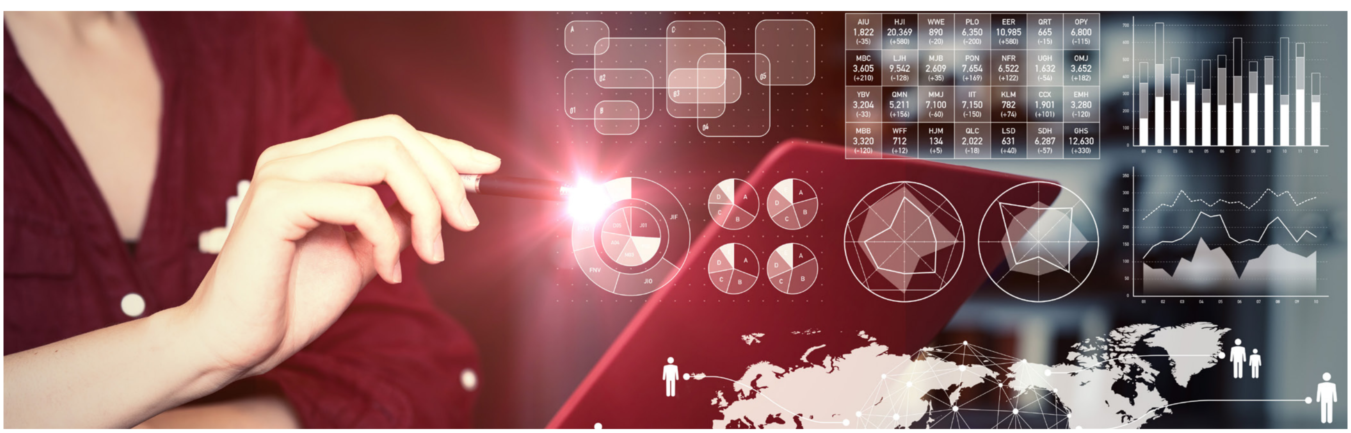
A brief analysis of what regulators are saying about the Form F filing will provide valuable context as further changes to the HCA are considered. In terms of the overall effectiveness of Form F reporting, it is safe to say that regulators to a large extent think it is either only somewhat effective or ineffective, with nearly one-third of respondents indicating that Form F reporting was ineffective. Similar results were produced when asked about the value the ERR provides to state regulators. Some of the reasons cited for the ineffectiveness or lack of value/utility can be attributed to filers not providing useful information; however, some regulators indicated conditions were improving and conversations between the regulator and the group helped facilitate an improved filing the next time. This gets at the bigger picture of what regulators want to achieve, as well as how and whether the ERR is the best method to communicate information to the regulator, particularly given the sensitive nature of the information disclosed.

[7] Form F Effectiveness Survey - https://content.naic.org/sites/default/files/inline-files/committees_e_isftf_group_solvency_related_form_f_survey_results.pdf

When asked which areas of enterprise risk included in the Form F reporting template provided the greatest value, most survey respondents agreed that all the areas could provide significant value but it depended on how the filing is interpreted and completed. One of the goals regulators clearly want out of the ERR filing is for there to be identification of any material non-insurance risks and for companies to indicate their means of addressing non-insurance operations. The problem with requirements of this nature, where insurers are being asked to identify material activity that could adversely impact the holding company, is providing incomplete information could create a liability but over-reporting could result in unnecessary regulatory examinations. It is a no-win situation for insurers. Further, the prognosis of what will impact the holding company in the future is very difficult for small companies that do not employ risk management teams or economic experts, highlighting the disproportionate impact the ERR has on small companies.

Probably the most significant finding to come from the survey was the volume of suggestions respondents provided when asked to describe what additions, deletions, or improvements should be considered. The suggestions ranged from requesting filers to be more specific in their written responses, describing its ERM framework in more detail, exempting ORSA filers, and even identifying several items that are duplicative with other regulatory filings. The range of responses speaks volumes to the diversity and sophistication of IHCS that complete Form F filings. Moreover, it resulted in the NAIC issuing a Form F implementation guide in 2018 to be used as a best practice guide for preparing and reviewing Form F filings[8].

While state regulators and the NAIC acknowledge the challenges presented with the Form F filing, it continues to be a requirement for all IHCS today. There is reason for optimism, however, as state insurance regulators are starting to acknowledge the faults of one-sized-fits-all regulation and are warming up to the idea of providing exemptions and allowing regulator discretion to determine how an insurance group should comply with holding company regulations. There are several parallels between the ERR and the GCC: they are both tools to be filed by the ultimate controlling parent, each target non-insurance entity risk, both were intended to apply to large and complex holding companies, each disclosure is duplicative, each involves significant resources to comply with, and they are both applied disproportionately impacting smaller IHCS. For these reasons, it is important that regulators consider a size-related exemption and other alternative approaches. In NAMIC's view, it is prudent to include an exemption in the HCA that would exempt insurers from both filings if it writes less than $500 million in direct written and unaffiliated assumed premium annually. Further, NAMIC takes the position that certain IHCS should be allowed to supply to the lead state annual RBC reports in lieu of an annual GCC report.



[8] Form F Implementation Guide: https://content.naic.org/sites/default/files/inline-files/committees_e_isftf_group_solvency_related_form_f_guide.pdf

Like the ERR, the primary purpose of the GCC is to help regulators understand large and complex groups, or more specifically, to aid regulators in assessing the risks coming from other non-insurance organizations within a groups' structure. In developing the GCC, the NAIC started with the RBC formula and began examining the section that addresses affiliate risk, ultimately landing on an aggregation approach. This approach involves the collection of a full inventory of companies, including select financial information like net income, premiums, liabilities, debt, etc. to be databased by state regulators; accounting for all available capital/financial resources; and required regulatory capital based on the valuation of assets and liabilities of the various corporate entities. The GCC is designed to be applied at the ultimate controlling parent level and to be filed with the lead state regulator. Included in the current proposal are instructions for completing the GCC as well as expectations for how the GCC will be used:

> "[T]he GCC will deliver an important set of information and capital ratio to facilitate earlier engagement with company management regarding potential business operations of concern and communication with other insurance regulators.[9]"

The amount of data and information that will be required to compute and file the GCC is significant and duplicative for many IHCS. This can be illustrated by following how the current RBC formula is constructed and how it works today for insurance groups. For insurance companies that are the ultimate controlling parent of the group, all the activities and investments made, including those in any subsidiary insurers, are rolled up into the parent's insurance RBC calculation. U.S. RBC for a top-tier insurance underwriting holding company is a proxy for consolidation, therefore annual RBC reports for a top-tier insurance company produces substantially similar results to what would be expected with the GCC. This has been validated by participants in the GCC field-testing exercises. For these reasons, NAMIC supports the use of the annual RBC report from the ultimate controlling person should be an acceptable alternative to requiring an annual GCC report and any associated financial information, so long as the expected results of the GCC would be substantially similar to RBC.

Taking a more proportional and principled approach to exemption criteria is not without precedent. Other NAIC model laws and regulations include size-related exemptions, including ORSA and the MAR. Other regulatory approaches, such as risk-focused surveillance examination and analysis, take on a more principled approach to solvency oversight. However, small IHCS continue to be disproportionately impacted by regulations designed for very large and complex holding companies. Furthermore, non-complex holding companies controlled by the insurer are getting scoped into new regulations designed for much-more complex holding company arrangements.

While any new requirement presents potential concerns and uncertainty for all companies, larger companies employ full-time legal, internal audit, accounting, finance, and ERM staffs. There will still be a cost for these large companies as there is for any new form requirement, but without a doubt, the cost of compliance and accuracy is a higher percentage of annual revenue for small companies. Therefore, a principled and proportionate approach to holding company regulation needs to be incorporated as part of the decision-making process when making changes to the HCA.

[9] GCC Proposed Instructions: https://content.naic.org/sites/default/files/inline-files/cmte_e_grp_capital_wg_field_testing_2019_proposal%5B1%5D.pdf

CONCLUSION

The HCA has been around for more than 50 years in some form and has undergone numerous amendments during that time, yet still more changes are on the horizon for holding company regulation. Now is the time to step back, look at the big picture, and ask the question: Are all these new regulations working as intended? Recall that the intent behind tools like the ERR and GCC is to assist regulators in addressing the systemic risk created by a few very large and complex insurers engaging in non-insurance activities. As state insurance regulators grapple with what the next version of the HCA looks like, understanding the drawbacks of applying one-size-fits-all regulations is critical and avoiding the lure of uniformity for uniformity's sake is prudent and principled regulation.

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