Memo

To: Kevin M. McCarty, Chair (Florida), NAIC ComFrame Development and Analysis (G) Working Group

cc: Ryan Workman, NAIC International Insurance Program Counsel

From: Pat Tracy, LeeAnne Creevy and Tricia Matson, Risk & Regulatory Consulting, LLC ("RRC")

Date: April 9, 2015

Subject: RRC Response to the Positions Statements on ComFrame and the International Capital Developments

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Background

On March 31, 2015, the National Association of Insurance Commissioners ("NAIC") ComFrame Development and Analysis (G) Working Group ("CDAWG") exposed draft revised versions of the NAIC positions statements on ComFrame and the international capital developments that were discussed at the recent CDAWG meeting in Phoenix, noting that these documents have been updated in light of developments over the past year.

We agree with the current views of CDAWG on both International Capital Proposals and ComFrame and believe that the views and input to the International Association of Insurance Supervisors ("IAIS") are excellent.

RRC appreciates the opportunity to offer our comments. Should you have any questions, we would be glad to discuss our comments with you and the CDAWG members.

RRC Comments

We believe U.S. ORSA requirements are highly relevant to this dialogue. The first official U.S. ORSA reports will be filed during 2015. Additionally, the globally systemically important insurers ("G-SIIs") will have in-depth ORSA reports and mature economic models that U.S. regulators can review. We believe ORSA offers the following opportunities to support the dialogue:

1. The basic capital requirements ("BCR") will serve as the basis for the higher loss absorbency ("HLA") requirements in what eventually will become part of the insurance capital standards ("ICS"). ORSA information regarding stress testing and prospective solvency, at least for U.S. G-SIIs, will be useful in evaluating the recommendations of the IAIS regarding HLA requirements.
    a. To the extent U.S. regulators are involved in reviewing ORSA reports for G-SIIs (or potentially other large insurers), the general understanding that will be gained regarding the nature of risks, levels of stress, and implications on economic, GAAP, and Statutory balance sheets will be very useful in evaluating and discussing proposed HLA standards for applicability to U.S. insurers. We believe the NAIC could pursue addressing HLA standards with industry, while maintaining the confidentiality of individual company ORSAs. The spirit of our comment is to use the ORSA discipline to directly address the proposed HLA standards.
    b. Based on their own experience evaluating stress tests and prospective solvency for internal management and ORSA reporting purposes, large U.S. insurance companies could comment on global HLA stress factors being proposed through the current process afforded by the NAIC to interested parties.

c. If appropriate, the U.S. regulators could add guidance to the ORSA instructions to better cover key areas of stress and prospective solvency based on the evolving international requirements. The economic capital models used in ORSA should consider all known significant risks, including any appropriate HLA risks. However, such additions should strike an appropriate balance between enabling global consistency and maintaining the "own" element of ORSA.
d. If additional ORSA guidance regarding capital assessment were to be added for a subset of the largest companies (e.g., G-SIIs), ORSA could potentially serve as the U.S. equivalent for the ICS requirements.

2. To gain comfort with company internal capital models, U.S. regulatory review concepts could be applied to such models. We offer the following background and development thoughts:
   a. The actuarial profession has significant experience with modeling insurance and investment risks under both normal and stressed conditions. Judgment is needed for operational and strategic risks that have not been traditionally addressed by actuaries. While internal models typically involve significant model risk, this area is increasingly recognized as a risk, and insurers are mitigating this risk through increased resources, processes, systems, and controls specifically focused on model governance, review, and validations. This process is expected to improve further over the next 3-5 years. There is increasing guidance in this area, including whitepapers like that issued by the North American CRO Council and an actuarial standard of practice in development on modeling. Although future improvements are likely to be made, we note that historic insurance and investment risk modeling has been effective.
   b. Minimum and best practices for economic capital modeling and model risk controls and testing can be developed for G-SIIs. The larger companies meeting the G-SII profile requirements should be able to comply with best practices such as static and dynamic validations, input and output controls, back-testing, calibration requirements, and credibility assessments.
   c. While this process could take years, the existing U.S. regulatory foundation is in place to make it work. As an example, companies already use internal models for asset adequacy analysis, a reliable and valued process that has been part of the regulatory review process for many years. Also, the existing RBC capital framework for insurers prevented significant problems (like financial institutions faced) in the 2008 financial crisis.
   d. There is a long-term advantage to policyholders and companies with a risk-focused capital standard that is verifiable. ORSA and the U.S. framework allow for continuous development and monitoring of capital under stress.

3. The ORSA requirements can objectively demonstrate the effectiveness of the insurance model under stress. For example, Life and P&C companies have long-tail liabilities, and we believe that ORSA can clearly articulate, with verifiable data, how the assets and liabilities are expected to react under stress.
   a. Using well-developed and tested ORSA information should help the dialogue.
   b. The discipline of relating the risk to the capital needed is an area of strength of the U.S. ORSA process.
   c. The current risk-focused examination framework allows for review and testing of prospective risks. The stressing required by ORSA can be reviewed using this existing framework. As noted above, practitioner guidance will continue to develop in this area. The ability of the U.S. State-based process to understand, test and verify should be applied to ORSA.

4. We suggest a more explicit recognition of the potential challenges of a "GAAP Plus" valuation approach, in particular:
   a. The increasing disconnect between U.S. GAAP and International Financial Reporting Standards ("IFRS"), which will create discontinuity in valuation results in "baseline" as well as stressed conditions (for example, divergence in the approach for accounting for short duration insurance contracts).

   b. There are very large insurers that are non-public entities, and therefore may not currently have a robust GAAP reporting process.

5. We also suggest that a more flexible view on "market adjusted" could be beneficial.
   c. We agree that it is not appropriate as the sole approach.
   d. While we are in full agreement that a market value approach is not appropriate and can be overly volatile, with appropriate adjustments to reflect the unique nature of insurance liabilities, something more "economic" or "market adjusted" could potentially be appropriate. Perhaps the language could reflect that a market adjusted approach would need to carefully consider the nature of insurance contracts.
   e. We note that there is some connection between U.S. GAAP and a market adjusted approach, since assets and certain liabilities are reported on a market value like basis under U.S. GAAP.