Session 1: Risk-based capital: implementation experiences, challenges, and solutions.

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U.S. Risk-Based Capital: Background

- In the 1990's, following a number of insolvencies in the U.S. in the 80's, the NAIC and state insurance supervisors implemented a risk-based capital standard.

- Prior to that time, regulators generally used fixed capital standards as a primary tool for monitoring the financial solvency of insurance companies

- Capital standards weren't risk based:
  - Varied by State.
  - Were essentially a fixed dollar amount.
  - Did not consider the size of a company.
  - Did not consider the underlying risks written by a company.
  - Was not influenced by the type of assets used to back those risks.

Risk-Based Capital: Purpose

- **Purpose: Identify potentially weakly capitalized companies EARLY to facilitate regulatory actions designed to, in most cases, help ensure that policyholders will receive the benefits promised.**
- RBC reports are intended solely for use by the state in monitoring the solvency of insurers and the need for possible corrective action.
- RBC reports are confidential.
- We don't rank insurers through risk-based capital. We don't compare one company's ratio result to another.
- **Rather, we use the ratio as one (important) tool in our risk-focused solvency monitoring framework. Remember, it's not a complete picture.**

Risk-Based Capital: Formulas

- The RBC formulas are made up of components that represent the primary risks associated with that specific line of business. The following risks are included in each of the formulas:
  - **Asset risk**—is the risk associated with investments held by the insurer. This includes the possibility of default of principal and interest or fluctuation in fair value.
  - **Insurance (underwriting) risk**—is the risk of underestimating liabilities from business already written or inadequately pricing business to be written in the coming year.
  - **Insurance Affiliates and Misc. Other Risk** – is the risk from declining value of insurance subsidiaries as well as risk from off-balance sheet and other misc. accounts.

- No single formula can give a complete picture of a company's operations and risks.

- However, a properly designed formula will help in the early identification of companies with inadequate capital levels and allow for corrective action to begin sooner.

- **The RBC formulas are maintained and updated on an annual basis. The Capital Adequacy Task Force has procedures in place for ongoing updates and monitoring of potential needed changes.**

Risk-Based Capital: Thresholds

RBC Ratio	Action Level	Description
> 200%	No Action Required	N/A
150% - 200%	Company Action Level	Company Submits an RBC Action Plan
100% - 150%	Regulatory Action Level	Director May Order Specific Corrective Actions
70% - 100%	Authorized Control Level	May Place Insurer Under Regulator Control
< 70%	Mandatory Control Level	Must Place Insurer Under Regulatory Control

- Ratio results are reported annually. We can estimate amounts quarterly, but these aren't as precise. RBC includes a trending mechanism, where a company may find its in Company Action Level even if the ratio is above 200% but is trending down.

Risk-Based Capital: Challenges

- Some challenges of our Risk-Based Solvency Regime include:
  - Insurance products are ever changing; and
  - The limited experience data available to address emerging potential risks.
- While RBC is formulaic in nature, it is ultimately a subjective measure of capital that a company has versus capital that a company needs. Why? **Regulators design the formulas.** We keep the formulas generic and easily understandable while also attempting to react to evolving risks.
- **U.S. regulators continue to enhance their solvency regime through ongoing updates to their solvency regime, including RBC, accounting standards, updated group supervision tools including the group capital calculation, liquidity stress test, ORSA, and other steps forward.**
- One very current challenge is innovation in investments. We'll touch upon this and some other examples as to how risk-based capital, and our overarching system of risk-focused solvency, react to these developments.

Risk-Based Capital: What's Happening Now?

- The **Capital Adequacy Task Force** (CATF), under the Financial Condition (E) Committee, is directly responsible for maintaining and updating the RBC formula.

- Working groups that provide technical expertise to the CATF include:
  - Health Risk-Based Capital (E) Working Group
  - Life Risk-Based Capital (E) Working Group
  - Property and Casualty Risk-Based Capital (E) Working Group
  - Risk-Based Capital Investment Risk and Evaluation (E) Working Group
- Various Risk Evaluation Ad Hoc subgroups are also meeting, including:
  - RBC Purposes & Guidelines Ad Hoc Subgroup
  - Geographic Concentration Ad Hoc Subgroup
  - Asset Concentration Ad Hoc Subgroup

Risk-Based Capital: What's Happening (con't)

- **The RBC formulas are under constant review.**
  - The Health RBC Working Group is reviewing (1) underwriting risk and (2) excessive growth risk charges.
  - The Life RBC Working Group is reviewing (1) what areas of the formula should be updated; (2) mortality risk updates; and (3) the covariance formula.
  - The Ad Hoc subgroups are undertaking a number of reviews, including evaluating (1) the RBC factors; (2) excessive growth risk charges; (3) updates to the Purposes and Guidelines of the RBC Preamble; (4) asset concentration factors; (5) geographic concentration, among many other topics that were considered.

U.S. regulators receive support from a broad array of industry experts, from regulators, the American Academy of Actuaries, trade groups, and company experts.

Risk-Based Capital: Impacted by Accounting Standards

- While the RBC formulas serve a key function, some of the most important and current items in our risk-based solvency framework are the accounting and reporting modifications that occur annually to keep up with current developments (such as investment innovations), and the activities which use the statutory financial statement data and other data (such as investment ratings).

- These requirements are the foundation for statutory financial reporting as well, which serves as the base for much of our solvency monitoring system.

- **Accounting and reporting requirements often directly influence a company's risk-based capital calculation as many of the statement balances are pulled directly into the RBC formula.**

- Importantly, updates to accounting and reporting then lead to updates to the RBC formulas to ensure a proper linkage and appropriate capital charges for the underlying risks.

Recent Updates to Accounting Standards

- **Principles-Based Bond Definition**
  - With the adoption of a principles-based bond definition, classification as a bond will depend on the substance of the investment and whether the investment produces bond-like cash flows over the life of the instrument.
  - The adoption of the principles-based bond definition, which is effective Jan. 1, 2025, has also resulted in significant reporting revisions. These changes for more granular reporting requirements provide greater transparency allowing regulators to identify and understand the different investment risks for bond investments.
  - As noted, updates to accounting and reporting will often move in parallel to related updates to the risk-based capital formulas to ensure an appropriate capital charge.

Other Recent Changes

- The establishment of specific accounting and reporting guidance for “residual interests.”

- Residuals are often characterized as the “loss layer or equity tranche” of investment structures that absorb defaults from the discrete pool of collateral generating cash flows for the structure before those losses impact the principal and interest payments to debt tranche holders.

- Residual interests have been noted as a growing investment, so specific accounting and reporting guidance was deemed necessary.

- Another key change in response to market developments is that prior statutory guidance only addressed one form of federal tax credits – “from investments in low-income housing.”

Risk-Based Solvency: GCC and LST

- Group Capital Calculation (GCC)
  - NAIC began development of a GCC in 2015.
  - The GCC is another tool for regulators to better understand an insurance group's financial risk profile.
  - Provides an analytical framework for evaluating capital positions of affiliated entities within an insurance group.
  - Applies to almost all insurance companies within a group.

- Liquidity Stress Test (LST)
  - NAIC began development of an LST framework.
  - Provides another lens harnessing granular-level data in the financial statements to assess macroprudential impacts on the broader financial markets of a liquidity stress affecting a number of insurers simultaneously.
  - Currently applies to select large life insurance groups, including two in Michigan.

Risk-Based Solvency: ORSA in the U.S.

- The U.S. ORSA came about following the 2008 financial crisis as regulators re-evaluated our risk-based solvency regime.

- **The ORSA applies to any individual U.S. insurer that writes more than $500 million of annual direct written and assumed premium, and/or insurance groups that collectively write more than $1 billion of annual direct written and assumed premium.**

- A majority of states have formally enacted NAIC Model law #505 (ORSA Law), which was added as an NAIC accreditation standard in 2017, meaning if states wish to be accredited by their peers, they must have passed the ORSA Law.

- **Risk-based capital is a generic tool used to capture an insurer's risks. A company should have a company-specific review and assessment to understand their risk profile**.

Risk-Based Solvency: Steps Forward

- As supervisors, we need to get a full picture of the group's activities, and as such, states embrace the three "C's process - communication, coordination, and collaboration.

- The NAIC refers to this process as the "lead state" approach for insurance groups. In 2011, the NAIC adopted revisions to its Model Insurance Holding Company System Regulatory Act and Regulation to enhance the "windows and walls" approach to group supervision.

- The revisions provide for a U.S. insurance regulator to participate in a supervisory college with other regulators for supervision of a domestic insurer that is part of an insurance holding company system with international operations.

In Michigan…

- In Michigan, we regulate 139 insurance companies, 26 health maintenance organizations, and various other licensed companies.
- Michigan is actively involved at the NAIC across its leadership and committee structures to engage in discussions about enhancements to risk-based solvency, including RBC.
- Michigan engages in bilateral discussions with regulators both within the 50 states and globally through supervisory college meetings, sharing of analysis and exam reviews.
- Enhanced group supervision, including ORSA and the recent group capital calculation, allow for a more comprehensive look at the overall risk and capital within a group.
- Risk-based capital is a critical tool to ensure that companies meet and maintain robust capital thresholds.
- Companies exhibiting solvency concerns, assessed both through the RBC calculation filings and many other analytical tools, are subject to increased levels of oversight up to and including some form of receivership.

Questions?