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CRE READING PROGRAM QUESTIONS

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The Reading Program Test from this issue and future issues of the *Examiner* will be offered and scored online. Please see the details on the previous page.

ORSA as a Tool for Analysts and Examiners

True or False Questions — Submit Answers Online

1. Many insurers are preparing for ORSA now by preparing mock ORSA reports.
2. ORSA's objectives are to foster ERM while ignoring risk and capital.
3. Preparing an ORSA report will be easier for insurers that already have an embedded ERM process in their company.
4. ORSA will help analysts, examiners and other regulators to quickly evaluate key risks for a particular insurance group.

The Impact of Emerging Risks and Trends upon the NAIC Financial Analysis Handbooks

True or False Questions — Submit Answers Online

1. The United States is one of the few nations in which its insurance regulatory system performs quarterly financial analysis on the majority of its domestic insurance companies.
2. All states are not required to utilize the Financial Analysis Handbook; however, all states implement at least some aspects of the Handbook, such as the I-SITE automated Level 1 Procedures, Level 2 procedures, and Supplemental procedures.
3. The Financial Analysis Handbook Working Group adopted new First Quarter Level 1 procedures for non-troubled insurers in 2010.
4. Accreditation Review requirements for Holding Companies were in enhanced to strengthen the depth of review and level of documentation guidelines, as well as introducing new expectations on the part of the lead state.
5. A new Management Considerations supplemental procedure was added to the Financial Analysis Handbook in 2010 which consolidates many corporate governance related questions into one area.

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CRE READING PROGRAM QUESTIONS

(continued)

All quizzes MUST be taken online

Special Purpose Vehicles Driving NAIC Subgroup's Work

True or False Questions — Submit Answers Online

1. The Captive and Special Purpose Vehicle Use Subgroup was formed to study new forms of commercial auto insurance.
2. Captives are only allowed to domicile and form in a few states.
3. The growth in the number of captives over the past few years is attributable to the use of captives by direct writers of term and universal life insurance policies.
4. The Subgroup recommended that the Financial Condition (E) Committee form a separate subgroup to develop possible solutions for addressing the XXX and AXXX perceived redundancies.

Title Insurance: Overview and Key Regulatory Concerns

True or False Questions — Submit Answers Online

1. A lender's title insurance policy only protects the financial institution (i.e. mortgage company or bank) in the event that a valid title claim arises.
2. An owner's title insurance policy only protects the seller's interest in the real property in the event that a valid title claim arises.
3. Title insurance is different from all other types of insurance coverage in that it protects against events which occurred before the policy was purchased, as long as the title defect was not discovered at the time of the title search.
4. In 2007, the U.S. Government Accountability Office (GAO) issued a report describing unusual and troublesome aspects of title insurance, including a lack of price transparency and conflict of interest among sellers.
5. Four insurance company groups compose 100% of the available title insurance market.

ORSA as a Tool for Analysts and Examiners

By: Lewis D. Bivona Jr., CPA, AFE

While not in force, or for that matter, adopted by any states at this juncture, ORSA will become a critical tool for analysts and examiners to gauge risks of their domestic complex insurers. The NAIC has established an ORSA Guidance Manual which the NAIC is soliciting comments for by the end of the 2012. The draft NAIC ORSA Manual is intended to provide guidance to an insurer and/or insurance group of which the insurer is a member with regard to reporting on its Own Risk and Solvency Assessment (ORSA) as required by the domestic state's version of the NAIC Risk Management and Own Risk and Solvency Assessment Model Act.

Per the NAIC, an insurer that who is subject to the ORSA requirements will be expected to:

1. Regularly, no less than annually, conduct an ORSA to assess the adequacy of its risk management, and current, and likely projected future, solvency position;
2. Internally document the process and results of the assessment', and
3. Provide a high-level summary report annually to the lead state commissioner if the insurer is a member of an insurance group and upon request to the domiciliary regulator, if requested. Whether an applicable state insurance regulator chooses to request the confidential filing each year may depend on a myriad of factors, such as the nature and complexity, financial position, and/or prioritization of the insurer/group, as well as the economic environment considerations.

In a nutshell, ORSA has two primary goals:

1. To ingrain a process of enterprise risk management at all insurers via assessment of risks application of techniques that are appropriate that are appropriate to the insurers risk environment and capital considerations; and additionally to:
2. To provide a group-level perspective on risk and capital, in addition to the existing sole company picture.

We all know that risks can virtually wipe out a company overnight, the AIG meltdown had nothing to do with the insurance companies but everything to do with a risk that was not addressed in the financial services sector of the company. What ORSA means for companies is that they need to demonstrate to the regulators that they have a vibrant and dynamic ERM system which they can explain and plan for mitigation of risks. What ORSA means for analysts and examiners that are accustomed to evaluating company as a single operational unit must now "think outside of the box" and consider what risks affiliates and other related parties have that could impact the reporting entity and test those assumptions against what management portrays as risks. This process also envelops an evaluation of products and offerings made by insur-

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ORSA as a Tool for Analysts and Examiners

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ers to beg the question, what if? What if interest rates continue to drop, how does that affect my annuity products? What if I have two 100 year floods in the next ten years: how does that affect potential liability for insured properties caring casualty coverage? What if the recession continues, will it increase my exposures for workers compensation and disability policies? Once companies start asking themselves the "what if" questions, they can develop methodologies to mollify or reduce inherent risks.

While ORSA is not the answer to all risks, it is a change in mindset for insurers that do not have an ERM process to focus on what risks pose the greatest hazard to their entities. Much like the risk matrices guide examiners in evaluation of risks and controls that will help mitigate those risks; insurers will become more focused on addressing risks that are most potentially threatening to their solvency and deploying risk management techniques that would lower the likelihood of a bad outcome.

The process that ORSA follows is no different than those used in other industries, essentially a good ERM process outlines:

- Description of the Companies Risk Management Framework
- Company Assessment of Risk Exposure and Prioritization
- Assessment of how risks could affect company capital and overall solvency
- How to mitigate or eliminate risks to the greatest extent possible
- Evaluate problems that occurred and plan to minimize reoccurrence in future operating periods
- Repeat processes above

Think of the ORSA process as a financial disaster reaction/recovery plan. For analysts and examiners, the last thing they want to happen on their watch is for a regulated company to become insolvent. The best thing analysts can do for examiners is to evaluate and define operational risks as part of their review process. I have seen analyst work papers that clearly define what current stressors are for an insurer, but look right past emerging risks. For example interest risks may be noted since they stick out like a sore thumb for all insurers at this time in history, but what about:

- high volumes of loaned securities without proper collateral, or
- a life company with high surrender volumes, or
- a P&C company that has loss ratios that significantly exceed their geographic competitors, or
- a health insurer which is entering into a product in which they have no experience, or
- a legacy computer system that cannot be updated or perform advanced modeling capabilities

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ORSA as a Tool for Analysts and Examiners

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Would it not be important to ask management about these types of issues during an annual analyst meeting, and furthermore, document these emerging issues to be reviewed for an upcoming limited scope or full scope examination? Asking the what if questions, makes every regulator more effective. Focusing on what went wrong and how to fix it is important, but more importantly what can go wrong and how to prevent it seems a much more valiant and worthwhile pursuit.

While many insurers have business plans, very few spend sufficient time to incorporate them into ERM process. Solvency initiatives in the EU are uniquely focused on addressing risks and mitigation efforts; ORSA is the first step in addressing ERM and solvency risks in a coordinated manner for large entities in the US. ORSA is based on the Insurance Core Principles 16 and 17 which cover Enterprise Risk Management and Capital Adequacy/Internal Modeling, respectively. ORSA's objectives are to foster ERM while providing a perspective look at risk and capital. Developing worst case scenarios allows insurers to address current controls and control enhancements that may need to be developed.

Many insurers are preparing for ORSA now by preparing mock ORSA reports. Much like SOX, they are also preparing gap analyses related to their current state of readiness and planning how to remediate any deficiencies in their processes. The most difficult task that insurers will have is translating capital requirement over to a group perspective because most are used to reporting at the entity level.

While many insurers have business plans, very few spend sufficient time to incorporate them into ERM process.

Think of ORSA as a long term business continuity plan, remember, those that fail to plan, plan to fail!

About the Author

Lewis D. Bivona, Jr., CPA, AFE is the Insurance Practice Leader and Partner at WithumSmith+Brown, Certified Public Accountants and Consultants. He has over 33 years of experience in the healthcare and insurance industries. The depth of his experience has been garnered from high-level positions within the public accounting, HMO, consulting and hospital industries as well as a period in HMO regulation. Lew has been the team leader on many financial condition examinations of some of the largest insurance companies in the country. Lew has also lead and participated in the audits of ERISA health benefit plans; he has also been a presenter to numerous employee benefit groups across the region. In addition, Lew is an active member of the SOFE Publications Committee.

The Impact of Emerging Risks and Trends Upon the NAIC Financial Analysis Handbooks

By David Andrew Vacca, CPA

Introduction

The NAIC Financial Analysis Handbook (Handbook) has been a key risk-focused solvency monitoring tool in the U.S. Solvency Framework over the past 15 years. It provides a uniform baseline with regard to the depth of analysis that should be undertaken by states to identify solvency risks, evaluate and understand such risks and then develop appropriate corrective action plans.

Globally recognized around the world by insurance supervisors, the Handbook is internationally viewed as the premier off-site examination tool (or Rolls Royce model as a few non-US jurisdictions claim). Over the last seven years, international insurance supervisors from various jurisdictions, such as Australia, Brazil, Thailand, India, Germany, France, U.K., Poland, Switzerland, Peru, Chile, Singapore, Japan and China, have requested training and copies of the Handbooks. Sessions taught by NAIC Staff focused on how states utilize and maintain the Handbooks. All of these jurisdictions were overly complimentary of the Handbooks. However, these jurisdictions also recognized that the NAIC Financial Data Repository (FDR) serves as a catalyst for many of the procedures and the ability to perform annual and quarterly analysis, which is why the US remains one of the few jurisdictions (including G20 jurisdictions) that perform quarterly analysis on the majority of its domestics.

Globally recognized around the world by insurance supervisors, the Handbook is internationally viewed as the premier off-site examination tool (or Rolls Royce model as a few non-US jurisdictions claim).

The following paragraphs attempt to describe how the Handbook has evolved over time to respond to emerging risks and trends within the insurance industry, as well as the state regulatory environment.

Background

The Handbook is developed under the direction of the NAIC's Financial Analysis Handbook (E) Working Group (FAHWG) of the Examination Oversight (E) Task Force. Pilot programs to develop the Handbook editions for property/casualty and life/A&H began in 1995 and 1996, respectively. The Handbook editions were first released in February 1997. To date the Handbook includes a Property/Casualty and Title Edition, a Life/A&H and Fraternal Edition and a Health Edition.

Currently, the Financial Regulation Standards & Accreditation Program does not require all states to utilize the Handbook, as it does with the NAIC Financial Condition Examiner's Handbook. Instead, it allows a state to use checklists developed by the Department or obtained from the Handbook, and allows these checklists to be tailored to the particular needs of the analyst and insurer/group under review. However, for states that do not utilize the

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The Impact of Emerging Risks and Trends Upon the NAIC Financial Analysis Handbooks

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annual or quarterly Level 1 Procedures (checklist), Accreditation Team members will typically perform a comparative review to assess difference in order to determine if potential deficiencies exist.

The Chair of FAHWG has historically been one of the seasoned and peer leading solvency experts carefully selected to serve on the Financial Analysis (E) Working Group (FAWG) in order to ensure that new troubled company characteristics or adverse emerging industry trends were quickly incorporated into the analysis process. FAWG is a legendary, but highly confidential troubled company review regulator group that has served as a cornerstone in the US Solvency Framework for over 20 years. The current Chair of the FAHWG is Judy Weaver, Deputy Commissioner (MI), who is also a member of FAWG. FAWG has been responsible for numerous informal regulator only referrals to the FAHWG over the years.

The Handbook is utilized by all states in some respect. The majority of states utilize the I-SITE automated[1] annual and quarterly Handbook Level 1 Procedures. However, these states may allow seasoned analysts some flexibility regarding whether to use of Level 2 Procedures and Supplemental Procedures. The remaining minority of states will annually review the changes made to the Handbook by the FAHWG and incorporate desired edits into the states' own processes. States may also utilize the Handbook as an educational tool, given the vast Analyst Reference Guide that provides explanatory guidance for unseasoned analysts with regard to the majority of questions and risks found in the procedures. Lastly, a state may utilize the Handbook Summary tool to screen or prioritize its domestics. The tool essentially counts and summarizes the number of automated "Yes" responses by insurer on various chapters (e.g. Reinsurance, Cash flow and Liquidity, Unpaid losses and LAE, etc.). Insurers with more "Yes" responses would likely receive higher prioritization than others.

In addition to FAWG, several NAIC committees regularly send referrals to the FAHWG for consideration, including the Casualty Actuarial and Statistical (C) Task Force, Life Actuarial (A) Task Force and the Financial Examiners Handbook (E) Technical Group. However, recently the Group Solvency Issues (E) Working Group and the Corporate Governance (E) Working Group have had significant indirect impacts.. Such research efforts have lead to policy decisions at the Financial Condition (E) Committee; thus, assigning the FAHWG responsibility for implementing such regulatory initiatives into the analysis process.

Significant Emerging Risks and Trends

Over the past decade, there have been numerous emerging risks and trends that have resulted in material changes to the Handbook. A few significant changes are described on the following pages.

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The Impact of Emerging Risks and Trends Upon the NAIC Financial Analysis Handbooks

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Resource Constraints

After a failed attempt in 2010, a proposal to create a new First Quarter Level 1 for Non-troubled Insurers was adopted by the FAHWG in 2011 for 2012 first quarter only and revised in 2012 to focus solely on quantitative risk triggers and to apply to all three quarterly review periods beginning in 2013. Limited state resources was one of the drivers influencing the proposal, given the growing level of responsibilities analysts have been asked to undertake, including enhanced holding company analysis expectations, corporate governance risk review, ERM framework review, and supervisory colleges. These new responsibilities are added on top of the existing annual/quarterly reviews, compliance reviews, licensing (25 states use analysts for licensing), Form A and D reviews, etc. However, in reality, there are other drivers of equal importance. One driver is with respect to NAIC databases and solvency tools that have matured and proven to be successful with regard to the identification of potentially troubled insurers. Specifically, the data is cleaner and more robust, and the NAIC regulator only prioritization and analysis tools have become quite sophisticated. Another driver is the observation that the FAWG and Analyst Team System have proven to provide a significant crosscheck and safety mechanism in the US Solvency Framework. These two drivers have influenced many regulators belief that change to quarterly analysis procedures on non-troubled insurers was merely a natural evolution in the process, whereby supervisors may rely more on quantitative alerts, so staffing resources can focus on other enhancements to the framework, such as more screening of corporate governance risks or holding company system risks.

Alan Harder (Assistant Chief Examiner, Iowa Insurance Division) stated, “In Iowa we have found the change in the analysis process to permit a quantitative review of non priority companies during the first quarter review to be very practical in that 1st quarter results can be very benign for said companies. Thus allowing more time to be allocated to companies that potentially have issues to be delved into.”

Enterprise Risks

Limited holding company analysis has been performed by states since the adoption of the Insurance Holding company System Annual Registration Statement (Form B) within the NAIC Insurance Holding Company System Regulatory Act in 1969. However, the Handbook did not include holding company analysis procedures until around 2005 based on the work and referral of the Framework for Insurance Holding Company Analysis by the Insurance Holding Company (E) Working Group. Unfortunately, utilization of the checklist was limited as the standards and guidelines within the Financial Regulation Standards and Accreditation Program with regard to holding company analysis was limited. Specifically, the previous guidelines merely required holding company filings

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The Impact of Emerging Risks and Trends Upon the NAIC Financial Analysis Handbooks

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to be analyzed, to at least some extent by the Department for all domestic multi-state companies. After receiving recommendations to enhance group supervision practices from the International Monetary Fund during the 2009 US Financial Sector Assessment Program (FSAP), the NAIC Financial Condition (E) Committee during 2010 drafted an Accreditation proposal to strengthen the depth of review and level of documentation guidelines, as well as introduced new expectations on the part of the lead state, which were subsequently adopted by the F Committee.

The Accreditation enhancement influenced the FAHWG to review the previous Holding Company Analysis Procedures. The FAHWG recognized the procedures needed to represent that minimum depth of holding company analysis in order to create greater uniformity and ensure lead states and non-lead states with domestics in a group understand their individual and collaborative responsibilities for holding company analysis. However, the Holding Company Analysis Procedures were also enhanced, such as review of interconnectivity of affiliates, contagion from non-regulated entities, international insurance operations, coordination with other supervisors (e.g. banking supervisors, group-wide supervisor and international supervisors), and affiliated agreements from a consolidated perspectives (e.g. review of tax sharing agreements). Lastly, holding company and supervisory college best practices were included in Handbook to help state analysts navigate these new responsibilities.

International Supervisory Trends

International supervisory trends have also had considerable impacts to the Handbook. In October 2010, years of coordination and collaboration at the International Association of Insurance Supervisors led to a new enterprise risk management standard expecting insurance supervisors to require insurers to perform Own Risk and Solvency Assessments (ORSAs). NAIC reviewed this new standard and determined it would complement the US Solvency Framework. Thus, the NAIC adopted the Risk Management and Own Risk and Solvency Assessment (ORSA) Model Act, which resulted in a new FAHWG charge to incorporate guidance into the Handbooks to assist analyst in reviewing the annual ORSA Summary reports. Such guidance could come in the form of enhancements to legal entity ORSAs and/or group ORSAs depending upon where an insurer or group lies with regard to the Model Law exemptions.

Corporate Governance Risks

For over a decade, the Handbook included various qualitative questions regarding corporate governance risks. Unfortunately, these procedures were spread throughout the checklists in various section and procedure levels. During 2010, the Handbook introduced a new Supplemental Procedure

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called Management Considerations that consolidated many corporate governance related questions spread throughout the Handbook into one area. It also incorporated new questions referred by the Financial Condition Examiners Handbook (E) Technical Group, who was also updating its respective Financial Condition Examiners Handbook related to the topic. Industry opposition to this new supplement was intense, claiming such procedures violated or conflicted with state corporate laws. However, the FAHWG held strong that "assessing" corporate governance risks does not violate state laws, as it poses no requirements. Regulators stated that risk assessment clearly falls within the scope and authority of the state insurance departments.

Time will tell whether the Management Considerations Supplemental Procedures will be utilized by states or not, as there is no Accreditation requirement related to assessing corporate governance risks. Per discussion with a few Chief Analysts, most require their analysts to perform the procedures for priority insurers.

Recently, the International Association of Insurance Supervisors has adopted new standards related to Corporate Governance that will be reviewed in the next 2014 US FSAP by the International Monitory Fund. It is likely this event will motivate E Committee to propose Accreditation standards to ensure certain Handbook procedures related to assessing corporate governance risks is performed.

Other Emerging Risks and Trends

Other emerging risks and trends that resulted in Handbook changes over the last five years includes the following:

- Due to lack of analyst use of Level 3 procedures, during 2008, 2009 and 2010, the FAHWG began merging the Level 3 qualitative questions into the more quantitative Level 2 procedures. To date, no Level 3 procedures exist.
- As a result of an increase in captive insurers using the NAIC Blank to file GAAP financials, a new Captive and/or Insurers Filing on a U.S. GAAP Basis Supplemental Procedure was developed to assist analysts in understanding key differences with common statutory accounting, ratios and I-SITE tools that would not be identified using the regulator Level 1.
- Impacted by the financial crisis, several small fraternal societies and title insurers voluntarily dissolved and/or went into receivership. As a result, FAWG petitioned the NAIC to create more automated solvency tools to assist state analysts. The FAHWG enhanced the Handbook by creating a Title and Fraternal Level 1 Procedures for the respective editions. The Level 1 Procedures were available during 2010, and the related automated checklists were available during 2012.

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- The financial crisis led to the discovery of new risks that could exist with regard to separate accounts. As a result, the FAHWG adopted new procedures in 2010 to utilize new separate account reporting disclosures by insurers. During 2011, the FAHWG incorporated additional guidance and procedures covering certain risk areas, such as general account guarantees, and insulated versus non-insulated product considerations.
- New Accreditation requirements related to the Regulatory Asset Adequacy Issues summary (RAAIS) resulted in enhanced guidance and new procedures for analysts within the Life/A&H Handbook.
- The new health care law resulted in development of a Supplemental Health Care Exhibit (SHCE) to better assist the US Health and Human Services Department in its regulatory efforts. However, the state analysts also had responsibilities with regard to the SHCE. Thus, the FAHWG created Level Two procedures to focus on the following: Compliance in reporting on the SHCE; review preliminary MLR and its components; review liability for rebates; concerns regarding rate filings; review of per member per month data; etc.

Conclusion

The Handbook has continuously evolved over the years to remain an effective solvency monitoring tool in the US Solvency Framework. Future success is likely, given the FAHWG's commitment to being responsive to emerging risks and trends in the insurance industry, as well as the state regulatory environments.

About the Author

David A. Vacca, CPA is the Principal of Vacca Regulatory Consulting, LLC. He provides insurance regulatory consulting services to state insurance departments, federal agencies, insurance trade associations, consulting firms, and other interested parties. Prior to starting his own firm, Mr. Vacca had responsibility overseeing the operations of the Insurance Analysis & Information Services Department and International Insurers Department (i.e. Surplus Lines) within the Financial Regulatory Affairs Division. In that role, he provided support services to state insurance regulators related to financial solvency, including group supervision, receivership, surplus lines, and financial analysis areas. He was also responsible for maintaining and enhancing NAIC financial solvency and receivership tools, served as a technical expert to international and federal regulators on U.S. financial insurance regulation and financial data requests, and monitored and reported on the US financial insurance industry trends to NAIC Members. Mr. Vacca has also served as the Accreditation Manager for the NAIC for two years. Prior to joining the NAIC, Mr. Vacca was a certified public accountant performing assurance and consulting services for five years with the international accounting firm, KPMG LLP.

Special Purpose Vehicles Driving NAIC Subgroup's Work

By Les Schott, CFE, CPA

The National Association of Insurance Commissioners (NAIC) Captive and Special Purpose Vehicle Use Subgroup appears to have taken dead aim on the life insurance industry's use of captive reinsurers and special purpose vehicles. The Subgroup was formed in early 2012 to study insurers' use of captives and special purpose vehicles to transfer insurance risk, other than self-insured risk, in relation to existing state laws and regulations and establish appropriate regulatory requirements to address concerns identified in this study. On October 17, 2012, the Subgroup exposed a draft white paper, Captives and Special Purpose Vehicles, which contained its initial findings and recommendations.

Captives were originally created to allow non-insurance companies to set up subsidiaries to insure their company's own risk, and can take various forms. These include pure captives (an insurer that only insures the risks of company affiliates), association or group captives (an insurer that insures the risks of member organizations), agency captives (an insurer owned by insurance producers insuring only the risks of policies placed through their owners), as well as many other forms. Currently more than 30 states, the District of Columbia, and the U.S. Virgin Islands allow captives to domicile and form in their state.

The number of captive insurers and captive domiciles has grown over the past few years, and much of this growth is believed to be attributable to the use of captives by direct writers of term life insurance policies with long-term premium guarantees and universal life insurance policies with secondary guarantees (ULSG). Captives are being used as a means of dealing with perceived reserve redundancies in these products, brought about from the application of strict statutory reserving requirements. The concern is that through the broadened use of captives for this purpose, a shadow insurance industry is emerging, with less regulation and more potential exposure than policyholders may be aware of as compared to commercial insurers.

Captives are being used as a means of dealing with perceived reserve redundancies in these products, brought about from the application of strict statutory reserving requirements.

The statutory reserving requirements in question are Actuarial Guidance 38 (AG 38), created in 2003 to clarify the NAIC Valuation of Life Insurance Policies Model Regulation, also referred to as Regulation XXX. This guidance sets forth reserve requirements for all universal life products that employ secondary guarantees. AG 38 and Regulation XXX impose conservative assumptions and valuation methodologies for determining the level of statutory reserves that insurers are required to maintain under statutory accounting principles for term life insurance policies with long-term premium guarantees and for ULSG policies. Regulation XXX refers to the reserves

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required to be maintained for term life policies with long-term premium guarantees while Regulation AXXX or AG 38 refers to the reserves required to be maintained for ULSG policies.

These conservative assumptions have required life insurers to hold significantly higher amounts of reserves than were previously mandated, and have therefore limited the financial flexibility of these carriers. As a result, these NAIC Model Regulations have been the subject of much controversy. They have been amended numerous times in order to capture new products entering the marketplace.

The captives formed to deal with the redundant reserve issue are referred to as special purpose vehicles (SPV). A special purpose vehicle is a captive licensed and designated as a special purpose captive insurance company by the insurance commissioner of the state of domicile. Special purpose vehicles can take several forms. Special purpose financial captives are limited to issue only special purpose financial captive insurer contracts to provide reinsurance protection to the counterparty. Special purpose reinsurance vehicles facilitate the securitization of one or more ceding insurers' risk as a means of accessing alternative sources of capital and achieving the benefits of securitization. Limited purpose subsidiaries can also be created for reinsurance purposes.

The transaction structure is such that the redundant/non-economic reserves are transferred to the captive/SPV. The assuming captive or SPV then assumes the full statutory reserve liability and secures those reserves in various manners. The economic reserves are typically the expected losses plus a small margin for adverse development and are secured by assets held by the ceding company. The redundant reserves are secured by a letter of credit (LOC) that is to the benefit of the ceding company.

The NAIC Subgroup reached a consensus view that it was inappropriate for Captives and SPVs to be used as a means to avoid statutory accounting. Use of other means of accounting may be appropriate when risks under the entity/transaction are perceived to differ from commercial insurance risk. However, the practice of using a different entity or different structure outside of the commercial insurer to engage in a particular risk because of a perceived inadequacy of the regulatory framework should be discouraged.

The Subgroup, in the draft white paper, made the following recommendations:

1. **Accounting Considerations** – The Subgroup recommended that the Financial Condition (E) Committee form a separate subgroup to develop possible solutions for addressing the XXX and AXXX perceived redundancies. Additionally, the Subgroup recommended that additional guidance

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Special Purpose Vehicles Driving NAIC Subgroup's Work

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be developed by the NAIC to assist states in a uniform review of transactions, including recommendations for minimum analysis to be performed, as well as on-going monitoring of the ceding insurer, the captive and the holding company. Once developed, the guidance should be considered to be added to the accreditation standards to ensure consistency and uniformity among states.

2. **Access to Alternative Markets** – The Subgroup supports the use of solutions designed to shift risk to the capital markets or provide alternative forms of business financing. The NAIC's Special Purpose Reinsurance Vehicle Model Act (#789) was developed to provide a uniform framework for the implementation of capital market securitizations of commercial insurers' reserves. However, securitization solutions allowed for within the model are no longer being utilized, as other solutions are preferred today. The NAIC should consider re-evaluating the model and updating it as necessary to reflect those alternative markets solutions that are currently acceptable to state regulators. Further, the NAIC should encourage states to adopt the model and also consider making the model an accreditation standard in those states that have an active captive and SPV market.
3. **IAIS Standards** – The Subgroup supports the IAIS Guidance Paper on the Regulation and Supervision of Captive Insurers which states, in summary, that insurer or reinsurer owned or common controlled captives/SPV that are not otherwise self-insurance, should be subject to a similar regulatory framework as commercial insurers.
4. **Credit for Reinsurance Model Enhancements/Added Reinsurance Disclosure/Transparency** – The Subgroup recognizes that there will be situations where movement of the reinsured risk outside of the group may not be feasible, or practical. For such situations, the Subgroup recommended that a study be performed of the effects of and potential limits on the variability in qualified LOCs or any other security that may not provide the intended protections anticipated within the NAIC Credit for Reinsurance Model Law. With respect to existing captive/SPV transactions, the Subgroup recommends enhanced disclosure in ceding company statements regarding the impact of the transactions on the financial position of the ceding insurer.
5. **Confidentiality** – The Subgroup recommended that the Financial Condition (E) Committee study the issue of confidentiality related to commercially owned captive and SPVs more closely. Further work should also be done to insure the state or other functional regulator of a group obtains additional information from the captive regulator on a confidential basis to understand the details of captive/SPV transactions, both for

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> U.S and non-U.S captives. This may be in addition to any changes made to the Financial Analysis Handbook that may suggest specific considerations when performing holding company analysis on groups that utilize such arrangements. One recommendation in this regard is that each state that has a domestic insurer in the holding company structure should be notified of a transaction of an affiliate that involves captives or special purpose vehicles, even if that state's domestic insurer is not a party to the transaction. Additionally, the ability to ensure future communication of information through Supervisory Colleges should be addressed.

The comment period on the white paper ended November 16. On November 29, at the NAIC Fall meeting in Washington DC, the Subgroup received and discussed the comments on the white paper. The Subgroup concluded that there was some misinterpretation with respect to the intent of certain sections of the white paper. The Subgroup charged NAIC staff with making modifications to the white paper to clarify the Subgroup's intent on these sections. Most noteworthy were the sections dealing with International Association of Insurance Supervisors (IAIS) standards, the reason cited for an increase in captives and the characterization of the captive industry. Once the modifications are made by NAIC staff, and agreed to by the Subgroup, the Subgroup intends to hold a conference call to discuss and finalize any additional changes needed to finalize the white paper. Stay tuned.

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About the Author

Les Schott, CPA, CFE is a Managing Director with Invotex Group where he is responsible for assisting the firm's insurance industry and regulatory clients in the areas of solvency, financial examinations and financial reporting. Invotex Group provides accounting, examination, analysis, risk and financial consulting services to help the insurance regulatory community achieve its goals with respect to the financial oversight of insurers and with respect to the supervision, rehabilitation and liquidation of financially troubled insurers. Prior to joining Invotex Group, Mr. Schott served the Maryland Insurance Administration (MIA) for over 10 years as the Associate Commissioner of the Examinations and Auditing Unit of the MIA preceded by 6 years as Chief Financial Examiner. He was directly involved in and responsible for the review of the most complex transactions related to insurers regulated by the MIA, including troubled company workouts, mergers and acquisitions, as well as serving as the Insurance Commissioner' s primary advisor on financial issues. Throughout his career, Les has been active in the Society of Financial Examiners, including having served as president in 2005-2006.

Title Insurance: Overview And Key Regulatory Concerns

By David Keleher, ARM, CPCU, CIC, AIM

Introduction

It is important for state insurance regulators to understand how title insurance works and, more important, how title insurance differs from other regulated products. Irrespective of the title insurance regulations that a state legislature has put in place, consumers will likely turn to insurance regulators for answers to their questions about title insurance. The goal of this article is to acquaint the regulator with the basics of title insurance coverage and explain how title insurance differs from coverage provided by other policies. The article will also examine the state of the title insurance market and explore some of the key regulatory concerns spawned recently by a number of title insurance company insolvencies and title agent defalcations[1].

Title Insurance—How is it Different?

What does title insurance do?

Title insurance protects real estate purchasers and/or lenders from losses that arise after a real estate settlement as a result of unknown liens, encumbrances or other defects upon the title that existed prior to settlement. Examples of title defects include outstanding property taxes not paid by a previous owner, fraud or forgery of a prior deed or transfer, or a spouse or unknown heir who steps forward to make a claim against the title. If a claim were made, defending the claim could cost thousands of dollars in attorney fees and, if the claim were valid, could even cause the buyer to lose the property itself. A title insurance policy provides coverage for legal defense, as well as the coverage amount listed in the policy, which usually equals the purchase price of the real property.

Who is covered by title insurance?

For most Americans, purchasing real estate represents the largest single investment they will make. Given the cost of real estate, very few consumers can purchase home, vacation or investment properties by paying cash. Instead, we borrow the funds from banks, savings and loans, mortgage companies, or other lenders, granting them a secured interest in the property.

One of the conditions that lenders place on the buyer is that a lender's title insurance policy must be purchased in an amount equal to the mortgage loan. However, a lender's policy only protects the financial institution in the event that a valid title claim arises. In a worst-case scenario, a buyer could make mortgage payments for 20 or 30 years when an unknown title defect comes to light, creating a valid claim that causes the buyer to lose the title. The lender would be covered, to the extent of the outstanding mortgage, and the owner could lose the property and all equity acquired over the 20 years that he "owned" the property.

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To avoid this scenario, an option available to the buyer is the purchase an owner's title insurance policy. This would protect the buyer's interest in the real property. If the decision is made to purchase an owner's policy and a lender's policy at the same time, there may be considerable premium savings. In the title insurance business, this is known as a "simultaneous issue," and the premium rates charged for the owner's policy will be calculated on the difference between the amount of coverage provided to the lender (amount borrowed) and the amount of coverage provided to the owner (purchase price).

How is Title Insurance Different from Other Types of Insurance?

Before real property is transferred from the seller to the buyer, a title search must be conducted. Title searches are usually conducted by an attorney who researches the land records in the county court house and documents the chain of ownership of the property. The purpose of a title search is to identify all prior owners and any outstanding liens, encumbrances, encroachments, rights of way, easements and the like associated with the real property, so that the buyer is aware of them prior to settling on the property. As such, the title search can eliminate most of the risk from the transaction.

Anything that is identified during the search is generally excluded from coverage under the title insurance policy, since these liens, encumbrances, etc., Are now known and should be satisfied at the time of settlement so a legal title can be transferred. However, something may be missed during the search process, which could result in a claim being presented at a later date. Since the defect was not known at the time the title was transferred, coverage would be provided by the title insurance policy.

In this respect, title insurance is different from all other types of insurance coverage. It protects you against events that occurred before the policy was purchased as long as the title defect was not discovered at the time of the title search, whereas property, casualty, life and health insurance policies protect you against events that occur after you purchase the policy.

In addition, unlike other forms of insurance—such as life, medical or homeowners—that require an annual premium, title insurance has a one-time premium charge when the title policy is purchased, which is in effect until the property is resold or refinanced.

Title Insurance Company and Agent Regulation

In most states, insurance companies must possess a certificate of authority from the state insurance department to conduct insurance business lawfully in the state. Title insurance companies are subject to all capital and surplus

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requirements, as well as laws that require them to submit their policy forms and rates for approval by the department of insurance prior to issuing a policy in the state. Most title insurance companies appoint producers (agents) to underwrite the risks, collect the premiums and issue the title insurance policies.

A significant difference between title insurance company agents and regular property/casualty agents is that title agents also conduct the settlements or closings, as well as the escrow funds for mortgage payoffs, taxes, closing costs, realtor commissions, etc. Since these transactions sometimes involve hundreds of thousands of dollars, this is exactly the area where title defalcations take place. Dishonest agents can be tempted to misuse funds (i.e., Escrow theft) and fail to pay off loans.

State of the Title Insurance Market

The title insurance market is dominated by four major insurance groups: Fidelity National, First American, Stewart Title, and Old Republic. These four insurance groups represent close to 90% of the available market (figure 1); the remainder of the market is made up of smaller companies with much smaller market shares.

Figure 1. Title Premium—Top Four Underwriters

Group Code	Company Name	2011 Direct Premiums	2011 Market Share	2010 Direct Premiums	2012 Market Share
670	Fidelity National	$3,282,438,594	35.46%	$3,631,255,012	38.43%
70	First American	$2,383,571,660	25.75%	$2,423,585,049	25.65%
340	Stewart Title	$1,279,871,839	13.83%	$1,302,554,047	13.79%
150	Old Republic	$1,233,001,758	13.32%	$1,053,699,409	11.15%

Figure 2: Title Insurance Industry—Key Ratios

Loss Ratio 2011	Expense Ratio 2011	Combined Ratio 2011	Combined Ratio 2010	Combined Ratio 2009
11.8%	100.9%	112.7%	113.4%	115.2%

Figure 2 shows that the composite combined ratio for all title companies for 2011 was 112.7%, Reflecting slight improvement over previous years. The loss ratio for the industry was 11.8% In 2011 and the expense ratio was 100.9%. Title insurers historically have low loss ratios because title underwriters perform extensive underwriting research on subject properties before issuing a title policy. The research title insurance companies perform prior to issuing

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a policy is both extensive and expensive. Research costs, the need to fund long-tail loss reserves and high allocated claims expenses when a claim does occur, cause title insurance expense ratios to be higher than other property/casualty lines of insurance. This "pre-underwriting" enables the issuing company to avoid issuing coverage on any property with a "questionable" title history. Claims should be the exception.

Regulatory Concerns

In 2007, the U.S. Government Accountability Office (GAO) issued a report describing certain unusual and troublesome aspects of title insurance, including a lack of price transparency and conflicts of interest among sellers. The gao called for regulators to seek to improve consumers' ability to shop for title insurance based on price and to improve oversight of title agents by deterring inappropriate practices in the marketing and sales of title insurance.

The Title Insurance (C) Task Force and several of its working groups are looking more closely into these issues identified by the GAO. A subgroup of insurance regulators has begun work examining the feasibility of promoting effective consumer shopping for title agents and insurers without delaying real estate closing schedules. This subgroup is also working to develop best practices for the design and implementation of title cost comparison guides for consumers. The group is currently developing a checklist of items that should be included in a model guide for consumers.

The Task Force and its working groups continually review numerous regulatory concerns, including: licensing of title insurance companies and agents; title insurance company reserve adequacy; promoting competition in the title insurance market; and promotion of laws to avoid title company insolvencies.

Escrow Theft White Paper

The Escrow Theft White Paper (C) Subgroup has been charged to examine ways to mitigate the impact of title insurer and agent insolvencies on policyholders. The Subgroup has begun work on a white paper that is intended as a tool for regulators to research methods for combating and preventing escrow theft, title insurance theft and other forms of fraud associated with title insurance and closing services transactions. The white paper may also be used by the title insurance and closing services industry when evaluating their own enterprise risk management and auditing guidelines for combating escrow and title insurance premium theft.

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Areas the white paper will address include: gaps in insurance laws/regulations which lead to escrow theft; types of escrow theft and how the theft takes place (including recent cases and objective illustrations); potential tools and methods to address escrow theft; enhanced initial audits of agents/agencies by underwriters; market conduct examinations; and regulator and underwriter monitoring for warning signs of potential problems. The progress on the white paper can be followed on the Subgroup's web page[2].

Conclusion

Title insurance protects consumers (insureds) and lenders from possible defects in title. Without title insurance, lenders would be unwilling to make mortgage loans for real estate transactions. The coverage continues as long as the insured has an ownership interest in the property. Title insurance policyholders depend on state insurance departments to make sure title insurance companies have the financial means to respond if and when they file claims 20-30 years in the future.

Regulators are under scrutiny from the GAO, which expects states to do a better job of promoting competition for title insurance consumers. As the U.S. Economy slowly breaks free of the "Great Recession," regulators should expect calls from consumers asking about the financial strength of title insurance companies. Prudent regulators would be well-advised to keep current on title-insurance-related issues.

* This article contains information from "A Consumer Guide to Title Insurance—Maryland Insurance Administration." Additional information on title insurance can be found on their website: http://www.Mdinsurance.State.Md.Us/sa/docs/documents/consumer/publicnew/titleinsurancebrochure.Pdf

For more information about title insurance, or to sign up as an interested regulator or interested party, please contact: Bruce Ramge, Chair, Title Insurance (c) Task Force and Nebraska Director of Insurance (402-471-2201) or David Keleher (dkeleher@naic.org, 816-783-8238).

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[1] Defalcation happens when an agent with fiduciary duties misappropriates money. The term is commonly used in the title insurance industry when funds that have been placed in escrow to close an insurance transaction have been misused by a title agent.

[2] www.naic.org/committees_c_title_tf_escrow_theft_white_paper_sg.htm

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