SUBCHAPTER D. Risk-Based Capital and Surplus

28 TAC §7.401

1. INTRODUCTION. The Texas Department of Insurance proposes new §7.401 concerning risk-based capital and surplus requirements for insurers and health maintenance organizations. The proposed section addresses the minimum risk-based capital and surplus requirements for property and casualty insurers, life insurance companies, fraternal benefit societies, mutual life insurance companies, stipulated premium companies, HMOs and insurers filing the NAIC Health blank. The proposed section will replace the existing risk-based capital rules in §§7.401, 7.410 and 11.809. The new section is necessary to adopt by reference the 2003 and 2004 NAIC Life Risk-Based Capital Report Including Overview and Instructions for Companies, the 2003 and 2004 NAIC Fraternal Risk-Based Capital Report Including Overview and Instructions for Companies, the 2003 and 2004 NAIC Property and Casualty Risk-Based Capital Report Including Overview and Instructions for Companies, and the 2003 and 2004 NAIC Health Risk-Based Capital Report including Overview and Instructions for Companies. The proposed section will also provide for specific actions by the commissioner or the reporting entity when the total adjusted capital of the reporting entity falls to certain levels.

The department has been following these standards for screening purposes subsequent to the authorization by the Legislature of risk-based capital standards in 1991. The risk-based capital requirement is a method of ensuring that an insurer has an appropriate level of policyholders' surplus after taking into account the underwriting, financial, and investment risks of an insurer. The NAIC risk-based capital formulas provide the department with a widely used regulatory tool to identify the minimum amount of capital and surplus appropriate for an insurance company to support its overall business operations in consideration of its size and risk exposure. Copies of the documents proposed for adoption by reference are available for inspection in the Financial Division of the Texas Department of Insurance, William P. Hobby Jr. State Office Building, 333 Guadalupe, Austin, Texas. To facilitate the consolidation of the risk-based capital rules in one section, new §7.401 is being proposed simultaneously with the proposed repeal of §§7.401 and 7.410. Notice of the proposed repeal appears elsewhere is this issue of the Texas Register.

2. FISCAL NOTE. Ms. Betty Patterson, Senior Associate Commissioner, Financial Program, has determined that, for each year of the first five years the new section will be in effect, there will be no fiscal implications for state or local government as a result of enforcing or administering the section. The proposal will have no anticipated effect on local employment or local economy.

3. PUBLIC BENEFIT/COST NOTE. Ms. Patterson has also determined that for each year of the first five years the new section is in effect, the section will enable the department to more efficiently and effectively utilize existing resources in the review of companies' financial condition, to more efficiently monitor solvency regulation of the insurers subject to the new section, and to implement the most current risk-based capital requirements. The cost to complete the risk-based capital report varies from insurer to insurer. Each insurer subject to the section would be required to acquire NAIC risk-based capital software at a cost of approximately $600 for each insurer. The labor cost to transfer the information from an insurer's records to the applicable report

will vary depending on the size of the insurer and the character of its investments. If an insurer uses the annual statement software that conforms to NAIC specifications provided by authorized vendors to prepare its annual report, and if that software is linked to the risk-based capital formula software, the department estimates that the information can be transferred and the formula completed in four hours or less. If the annual statement software is not linked to the risk-based capital formula, the department estimates an insurer can transfer the information from its records to the risk-based formula in 8-16 hours. The department's estimations are based upon discussions with industry representatives who are responsible for maintaining accounting records. Based upon the department's experience, an insurer would utilize an employee who is familiar with the accounting records of the company and accounting practices in general and who is compensated from $17 to $30 an hour. On the basis of cost per hour of labor, there is no anticipated difference in the cost of completing the formula between insurers who are micro, small, and large businesses. After the completion of the formula, it will likely be reviewed by an officer of the insurer who is responsible for the preparation of the financial reports of the insurer. In small insurers such officers are compensated at approximately $40 per hour, while such officers at large insurers are compensated at approximately $100 per hour. Based on the department's experience, the cost of compliance for small insurers would be less than the cost of compliance for large insurers in reviewing the risk-based capital report. Therefore, it is the department's position that the proposed section will have no adverse economic effect on small or micro businesses. The department does not expect the formulas to require a level of capital that is significantly different from the current capital requirements since the department has been using the risk-based capital levels. For those companies previously subject to the risk-based capital requirements, the department does not anticipate any material increase in cost resulting from a required capital contribution. However, the formulas' intended function, to protect policyholders from the effects of insolvency, may require some companies to increase capital. To the extent any insurer must increase its capital as a result of the risk-based capital requirements, that cost is the amount of capital required and is a result of the statutory requirement. Regardless of the fiscal effect, the requirements of this section are mandated by the underlying state statutes, and considering the statutes' purposes, it is neither legal nor feasible to waive or modify the requirements of this section for small and micro businesses, as doing so would result in a disparate effect on policyholders and other persons affected by the new section.

4. <u>REQUEST FOR PUBLIC COMMENT</u>. To be considered, all comments on the proposal must be received in writing no later than 5:00 p.m. on January 24, 2005. All comments should be submitted to Gene C. Jarmon, General Counsel and Chief Clerk, Mail Code 113-2A, Texas Department of Insurance, P. O. Box 149104, Austin, Texas 78714-9104. An additional copy of the comments should be simultaneously submitted to Betty Patterson, Senior Associate Commissioner, Financial Program, Mail Code 305-2A, P. O. Box 149104, Austin, Texas 78714-9104. A request for a public hearing should be submitted separately to the Office of the Chief Clerk.

5. <u>STATUTORY AUTHORITY</u>. The new section is proposed under the Insurance Code Articles 1.10, 1.32, 21.21, 21.28-A and §§36.001, 822.210, 841.205, 843.404, 885.401, and 884.206. Article 1.10, §5 addresses the duties of the department when an insurer's solvency is impaired. Article 1.32 authorizes the commissioner to fix standards for

evaluating the financial condition of an insurer. Article 21.21, §13 authorizes the commissioner to adopt rules necessary to regulate trade practices in the business of insurance. Article 21.28-A relates to the prevention of insurer delinquencies, supervision and conservatorship proceedings and authorizes the adoption of rules as necessary. Sections 822.210, 841.205, 884.206 authorize the commissioner to adopt rules to require an insurer to maintain capital and surplus levels in excess of statutory minimum levels to assure financial solvency of insurers for the protection of policyholders and insurers. Section 843.404 authorizes the commissioner to adopt rules to require a health maintenance organization to maintain capital and surplus levels in excess of statutory minimum levels to assure financial solvency of health maintenance organizations for the protection of enrollees. Section 885.401 authorizes the commissioner to require fraternal benefit societies to submit reports the commissioner deems necessary. Section 36.001 authorizes the commissioner to adopt any rules necessary and appropriate to implement the powers and duties of the Texas Department of Insurance under the Insurance Code and other laws of this state.

6. <u>CROSS REFERENCE TO STATUTE.</u> The following statutes are affected by this proposal: Insurance Code Articles 1.10, 1.32, 21.21, and §§822.210, 841.205, 843.404, 885.401, 884.206, 982.105, and 982.106.

7. <u>Text.</u>

<u>§7.401. Risk-Based Capital and Surplus Requirements.</u>

<u>(a) Purpose. The purpose of implementing a risk-based capital and surplus provision is to require a minimum level of capital and surplus to absorb the financial,</u>

underwriting, and investment risks assumed by an insurer or a health maintenance organization.

(b) Scope.

(1) Life companies. This section applies to any insurer authorized to do business in Texas as an insurance company that writes or assumes life insurance, annuity contracts or liability on, or indemnifies any one person for, any risk under a health, accident, sickness, or hospitalization policy, or any combination of those policies, in an amount in excess of $10,000 including: capital stock companies, mutual life companies, fraternal benefit societies, and stipulated premium companies doing business in other states. Fraternal benefit societies are subject to their own separate risk-based capital instructions as provided in subsection (d)(2) of this section. This section does not apply to stipulated premium companies only doing business in Texas.

(2) Property and casualty companies. This section applies to all domestic, foreign, and alien property and casualty companies subject to the provisions of the Insurance Code §§822.210 and 982.106, excluding those insurers that are only authorized to write mortgage guaranty insurance in all states in which they are licensed and excluding those insurers that write business only in this state and are not required by law to have capital stock.

(3) Health Maintenance Organizations and insurers required to file the NAIC Health Blank. This section applies to all domestic and foreign health maintenance organizations subject to the provisions of Insurance Code Chapter 843 and insurers that file the NAIC Health Blank with the department under department filing requirements.

(c) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Annual financial statement--The annual statement blank to be used by insurance companies, as promulgated by the NAIC and as adopted by the commissioner.

(2) Authorized control level--The result determined under the RBC formula in accordance with the RBC instructions.

(3) NAIC--National Association of Insurance Commissioners.

(4) RBC formula--NAIC risk-based capital formula.

(5) RBC instructions--NAIC Risk-Based Capital Report Including Overview and Instructions for Companies.

(6) Total adjusted capital--An insurer's adjusted statutory capital and surplus as determined under the RBC formula in accordance with the RBC instructions.

(d) Adoption of RBC formula by reference. The commissioner adopts by reference the following:

(1) The 2003 and 2004 NAIC Life Risk-Based Capital Report Including Overview and Instructions for Companies which includes the RBC formula.

(2) The 2003 and 2004 NAIC Fraternal Risk-Based Capital Report Including Overview and Instructions for Companies which includes the RBC formula.

(3) The 2003 and 2004 NAIC Property and Casualty Risk-Based Capital Report Including Overview and Instructions for Companies which includes the RBC formula.

(4) The 2003 and 2004 NAIC Health Risk-Based Capital Report Including Overview and Instructions for Companies which includes the RBC formula.

(e) Filing requirements.

(1) All companies, except fraternals, subject to this section are required to file electronically with the NAIC in accordance with and by the due date specified in the RBC instructions.

(2) Fraternals shall maintain a paper copy of the report for review by the department.

(f) Conflicts. In the event of a conflict between the Insurance Code, any rule of the department or any specific requirement of this section, and the RBC formula and/or the RBC instructions, the Insurance Code, rule or specific requirement of this section shall take precedence and in all respects control. It is the express intent of this section that the adoption by reference of the NAIC Risk-Based Capital Reports Including Overview and Instructions for Companies do not repeal or modify or amend any rule of the department or any provision of the Insurance Code.

(g) Actions of commissioner. The level of risk-based capital is calculated and reported annually. Depending on the results computed by the risk-based capital formula, the commissioner of insurance may take a number of remedial actions, as considered necessary. The ratio result of the total adjusted capital to authorized control level risk-based capital require the following actions *related to* an insurer within the specified ranges:

(1) An insurer reporting total adjusted capital of 150% to 200% of authorized control level risk-based capital institutes a company action level under which the insurer must prepare a comprehensive financial plan that identifies the conditions that contribute to the company's financial condition. The plan must contain proposals to correct areas of substantial regulatory concern and projections of the company's financial condition, both with and without the proposed corrections. The plan must list

the key assumptions underlying the projections and identify the concerns associated with the insurer's business. The RBC plan is to be submitted within 45 days. After review the commissioner will notify the company if the plan is satisfactory. In the event the commissioner notifies the company that the plan is not satisfactory, the company shall prepare a revised plan and submit it to the commissioner. Failure to file this comprehensive financial plan triggers the next lower action level described in this subsection.

(2) An insurer reporting total adjusted capital of 100% to 150% of authorized control level risk-based capital triggers a regulatory action level initiative. At this action level, an insurance company is also required to file an RBC plan or revised RBC plan with 45 days, and the commissioner is required to perform any examinations or analyses to the insurer's business and operations that is deemed necessary. The commissioner may issue orders specifying corrective actions to be taken or may require other appropriate action.

(3) An insurer reporting total adjusted capital of 70% to 100% of authorized control level risk-based capital triggers an authorized control level. In addition to the remedies available at the higher action levels, the commissioner may take other action deemed necessary, including initiating a regulatory intervention to place an insurer under regulatory control.

(4) An insurer reporting total adjusted capital of less than 70% of authorized control level triggers a mandatory control level which subjects the insurer to one of the following actions:

(A) being placed in supervision or conservation;

(B) being determined to be in hazardous financial condition as provided by the Insurance Code Article 1.32, and §8.3 of this title (relating to Hazardous Conditions) regardless of percentage of assets in excess of liabilities;

(C) **being** determined to be impaired as provided by the Insurance Code Articles 1.10, §5 or 3.60; or

(D) any other applicable sanctions under the Texas Insurance Code.

(5) A life insurer subject to this section is subject to a trend test if its total adjusted capital to authorized control level risk-based capital is between 200% and 250%. Any life insurer that trends below 190% of total adjusted capital to authorized control level risk-based capital would trigger the company action level.

(h) Prohibition on announcements. Except as otherwise required under the provisions of this section, the making, publishing, disseminating, circulating or placing before the public, or causing, directly or indirectly to be made, published, disseminated, circulated or placed before the public, in a newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio or television station, or in any other way, an advertisement, announcement or statement containing an assertion, representation or statement with regard to any component derived in the calculation, by any insurer, agent, broker or the person engaged in any manner in the insurance business would be misleading and is, therefore, prohibited. Any violation of this subsection may be considered a violation of Insurance Code Article 21.21 §(4)(2).

(i) Prohibition on use in ratemaking. The RBC instructions and any related filings are intended solely for use by the commissioner in monitoring the solvency of insurers subject to this section and in taking corrective action with respect to insurers and shall not be used by the commissioner for ratemaking nor considered or introduced as evidence in any rate proceeding nor used by the commissioner to calculate or derive any elements of an appropriate premium level or rate of return for any line of insurance which an insurer or any affiliate is authorized to write.

(j) Limitations. In no event shall the requirements of this section reduce the amount of capital and surplus otherwise required by provisions of the Insurance Code or the Texas Administrative Code, or by authority of the commissioner of insurance.

8. CERTIFICATION. This agency hereby certifies that legal counsel has reviewed the proposal and found it to be within the agency's authority to adopt.

Issued at Austin, Texas on ________________________, 2004.

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Gene C. Jarmon
General Counsel and Chief Clerk
Texas Department of Insurance