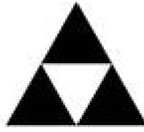

AMERICAN ACADEMY *of* ACTUARIES

Objective. Independent. Effective.™

December 16, 2014

Winnie Tsen
Senior Analyst
Financial Markets and Community Investment
Government Accountability Office
301 Howard Street, Suite 1100
San Francisco, CA 94105

Re: GAO Conference Call with the Academy on Global Capital Standards

Dear Winnie,

On behalf of the American Academy of Actuaries'[1] Financial Regulatory Task Force, I would like to provide the following written comments to the Government Accountability Office's (GAO) questions on global capital standards. These are to supplement and clarify the comments of representatives of the task force on the GAO's Nov. 7 conference call. We hope you will take them into consideration as you work on the global capital standards report.

1. In your view, to what extent do insurance companies pose systemic risk, as compared to banks?

Insurance companies, when engaged in traditional insurance activities, generally do not pose systemic risk but are exposed to systemic risk. However, there are some exceptions. Reinsurers that take on the risk of insurance companies or groups may be considered systemically important, depending on the composition of their portfolios. At this time, the Financial Stability Board is still considering how to identify and classify systemically important reinsurers. In addition, if an insurer is involved in a financial services group that is engaged in transactions with significant counterparty implications, that particular financial services group could be categorized as systemically important.

Insurers are fundamentally different from banks. Unlike banks, insurance liabilities are inextricably linked to their funding. That is, insurance liabilities arise from the sale of an insurance contract and are funded by the associated payment of premiums by policyholders, rather than by borrowing. There is no separation of funding and insurance operations.

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Furthermore, insurance liabilities are not as liquid as bank liabilities. Property-casualty and health claim liabilities are not callable. Many life insurance contracts do not have a cash option. For those life insurance policies that do, there frequently are contractual limits for which there are penalties and/or income taxes incurred upon premature surrender. Cash options are accessed only by the cancelation or surrender of an insurance contract. In addition, many life insurance contracts include a contractual right to delay cash surrender payments for up to six months. In times of financial difficulty, the functional regulator maintains the right to restrict the exercise of any cash withdrawal options from life insurance policies.

Insurance is purchased to provide protection against an insurable event. If policyholders forfeit this protection for individually underwritten life insurance policies, they may be unable to readily replace it. Moreover, in instances in which a life insurance company has experienced a significant increase in fund withdrawals, the impact has been confined to that company with no observed effect on other insurers or other financial institutions. Simply stated, insurance companies are not exposed to the same liquidity risk inherent to banks.

a. What factors determine whether insurance companies pose systemic risk?

When engaged in traditional insurance activities, it is difficult to envision how an insurance company would pose systemic risk. Systemic risk includes the impairment of financial intermediation, the impairment of financial function, and the inability to provide critical functions and services as key threats to the financial stability of the United States.

The impairment of financial intermediation relates to the impact of the failure of a financial services company acting as a counterparty to other financial institutions, as well as any resulting adverse impacts to those counterparties. The activities of individual insurance companies that are counterparties to other financial institutions are not of sufficient size, concentration, or interconnectedness to impact the financial stability of the United States. We recognize that there is still an open question as to whether and how reinsurers might be systemically significant in this context. This observation is based on an understanding of the insurance sector—the size of traditional insurers and the diversification of financial transactions among counterparties as a result of current regulatory requirements and typical risk management practices.

While an insurance company that is part of a financial services group may not have significant counterparty exposure to other financial institutions, the remainder of the financial services group may have entered into transactions with significant counterparty implications, thus resulting in a categorization of the group as systemically important.

The impairment of financial market functioning refers to the impact on asset values of a quick forced liquidation. As a result of the long-term nature of the insurance sector's liabilities, required asset adequacy testing by qualified actuaries, and the distressed company rehabilitation process under current functional regulation, forced asset sales resulting from a mandated liquidation rarely have occurred. The longer time horizon for insurance liability payments allows regulators to use tools other than additional capital infusions to address insolvency issues. In many cases, this results in the sale of the liabilities to other insurers without major losses to the customer or significant asset sales on the market.

An insurance company may no longer be willing or able to provide critical functions or services that are relied upon by market participants and for which there are no ready substitutes. Nevertheless, the voluntary withdrawal of a company from a market in which it has significant market share should not be considered a systemically risky event automatically. These events may occur as a result of changes in the risk profile of the market such that the risk assumption service(s) cannot be either priced or managed effectively. For example, there could be unintended consequences of a government mandate that may change the characteristics of a risk assumption service significantly. A new judicial precedent might affect the frequency and severity of claims such that the price of coverage affects affordability. In such cases, a company may not continue to provide a risk assumption service regardless of its importance. In these cases, the public policy focus should be on the changes in the risk profile of the coverage that affected the financial soundness of the coverage. In fact, this focus is already required in markets where there is strong regulation.

The potential systemic consequences of a cessation of critical risk assumption services under financial distress, however, could be considered a systemic event when there is the potential that a company's market share cannot be replaced by other providers of the service or function. Therefore, only those companies providing critical functions or services that are vulnerable to financial failure should be considered systemically risky. In most instances, however, replacements have surfaced within a reasonable period of time. For example, after Hurricane Andrew in 1992, a number of new start-ups assumed the risks of companies that exited the affected market.

b. *Is this different for life insurance companies versus property-casualty insurance companies?*

Life insurance companies and property-casualty companies are not fundamentally different with respect to systemic risk. When engaged in traditional insurance activities, neither contributes to systemic risk. Both life insurance, and to a much lesser extent, property-casualty companies are exposed to systemic risk. Since property-casualty insurance company risks are shorter term and less asset intensive, they have much less balance sheet exposure to systemic risk. On the other hand, the long duration of the liabilities of life insurance companies provides more time to work out an orderly liquidation in the event of a financial failure.

c. *Is this different for companies that are involved in non-traditional, non-insurance (NTNI) activities?*

Yes, to the extent that these NTNI activities involve capital market businesses at a scale that inherently constitutes systemic risk. It is appropriate to focus on non-traditional, non-insurance activities, especially those that typically do not fall under the purview of functional insurance regulators. These should be supervised in the same manner that any other institution contributing to systemic risk is supervised.

d. *Is this different for global systemically important insurers (G-SII) versus internationally active insurance groups (IAIG), versus other insurers?*

G-SIIs and IAIGs involved in traditional insurance activities, whether internationally or on a large scale, normally should not pose systemic risk. The level of systemic risk arising from a G-SII or IAIG depends on the extent of NTNI activities occurring in the group.

2. **Without knowing the precise International Association of Insurance Supervisors (IAIS) capital standards, what types of effects would you anticipate that U.S. insurers would likely experience if the IAIS proposed capital standards were implemented?**

   a. *What are the potential effects of the basic capital requirements (BCR) and/or high-loss absorbency (HLA) principles versus the more broadly applied international capital standards (ICS)?*

As indicated, it is too early to know precisely what the impacts of the BCR and/or HLA principles would be to U.S. insurers. However, we note that the BCR, which was finalized by the IAIS in October 2014, requires a "market-based" balance sheet approach to valuation. Mark-to-market accounting methods have the potential to generate non-economic, pro-cyclical volatility in the balance sheets of U.S. insurers, particularly life insurers writing long-duration, illiquid business. This could lead life insurers to reduce or eliminate long-duration product offerings (e.g., certain types of life insurance, annuities, disability income, and long-term care insurance products) to consumers, which, in turn, could reduce insurers' investments in long-term debt markets. Since the BCR is a minimum capital requirement to avoid insolvency, however, it is unlikely that insurers will feel more constrained than they currently do under U.S. risk based capital (RBC) requirements.

The development and implementation timeline for capital standards that are intended to apply across many jurisdictions and product types is aggressive. The current timeline includes several years of initial calibration. In addition, it is anticipated that the results will be kept confidential by the regulators. If properly executed, the risk of unintended consequences should be mitigated. These risks include:

- Poorly calibrated risk factors that do not appropriately reflect the underlying risks. This could cause companies to exit certain lines of business that require too much capital, in favor of lines of business that require too little capital;
- Basis risk from applying factors to an accounting standard that is not uniform or consistently applied; and
- Estimation risk resulting in too much or too little capital required in total.

As a point of reference the National Association of Insurance Commissioners (NAIC) RBC framework, which applies to U.S. companies writing U.S. products, was introduced in 1993 after a two-year development effort. It has continued to be refined and enhanced in the more than 20 years that have followed.

   b. *What types of actions would an insurer likely need to take in response to increased capital requirements?*

All else being equal, an insurer will increase prices or accept a lower return on equity (ROE). At a lower ROE, they will be less able to attract capital and, as a result, may have to shrink their business. This could reduce industry capacity and the availability of insurance to customers. If those capital requirements are only minimum requirements to avoid insolvency, however, then

there may be little or no effect since companies already hold higher capital requirements for rating agency purposes.

c. *How, if at all, would insurance companies that are not internationally active be affected?*

To the extent that IAIS standards are as high, or higher, than local capital standards, insurance companies that are not internationally active would not be affected directly. In fact, they may have a competitive advantage of lower capital requirements and expense savings due to avoidance of compliance costs. On the other hand, it is also possible that international standards eventually may represent best practice or influence rating agency requirements, in which case the impact would be significantly broader. We also note that while there are relatively few U.S. insurers designated as G-SIIs, the definition of an IAIG is more expansive (i.e., (1) less than $50 billion in assets or $10 billion in premium and (2) premium written in at least three jurisdictions with less than 10 percent outside the home jurisdiction).

d. *To what extent do you think that insurer actions to meet increased capital requirements would affect consumers?*

As stated above, if insurers are required to hold more capital than they currently do, prices would likely increase or availability would decrease.

e. *What are the potential positive and negative effects of having a single capital standard for all internationally active insurance companies?*

The most positive effect of having a single capital standard for all internationally active insurance companies is that it would create a framework for consistent comparison between companies. To the extent that it preempts local capital standards, it also could decrease compliance costs for such companies. Furthermore, if diversification credit is given, and if capital is assumed to be fungible in a group, then a lower, more efficient level of capital may be the ultimate result.

The negative effects of having a single capital standard include the implementation risk that a single standard may not be accurately calibrated across all jurisdictions and products. If diversification credit is given and if risks are correlated in a crisis situation, then capital may prove to be inadequate. Likewise, if capital is not fungible in a crisis situation, then a local entity that was presumed to be supported by the group may fail. Also, if local capital standards are preempted, then there may be dislocations in the local market as domestic-only companies are placed at a competitive disadvantage (or advantage) to international insurance companies.

3. In your view, to what extent is a group-level capital requirement, such as that proposed by IAIS, necessary in the United States?

a. *What would be the potential effects of implementing capital requirements at the group level?*

Please see the response to question 2e.

To the extent that a group capital requirement preempts local capital standards, it would decrease compliance costs for such companies. Also, if diversification credit is given and if capital is

assumed to be fungible in a group, then a lower, more efficient level of capital may be the ultimate result.

As to negative effects of having a group capital standard, if diversification credit is given and if risks are not uncorrelated in a crisis situation, then capital may prove to be inadequate. Likewise, if capital is not fungible in a crisis situation, then an entity that was presumed to be supported by the group may fail. In addition, if local capital standards are preempted, then there may be dislocations in the local market as stand-alone companies are placed at a competitive disadvantage (or advantage) to member companies of a group.

b. *Are there examples of other countries that are implementing or have recently implemented group level standards (for example, as a result of Solvency II) and did not previously have group level standards?*

We do not have enough information to give comprehensive analysis as to what has occurred in other jurisdictions.

4. **What types of costs might U.S. insurance companies incur if the United States were to implement group-wide capital standards such as those proposed by IAIS?**

It depends on the nature and structure of those standards. Costs may increase due to higher capital requirements or the expense of compliance. We previously commented on the impact of these costs to consumers on the Nov. 7th call.

5. **Are you aware of any insurers taking actions now in anticipation of potential changes in capital requirements? If so, please provide details.**

Some companies have taken action to prepare for and assess potential changes in capital requirements. These actions include modeling and stress testing the financial effects of the proposed BCR requirements and assessing the organization's capacity to report on a regular and reliable basis according to such a standard.

6. **What would be the likely competitive advantages and disadvantages for U.S. insurance companies if the United States did not implement international capital standards?**

In the absence of a group capital standard, there is no apparent advantage or disadvantage for U.S. companies if the United States does not implement international capital standards assuming that all companies operate in each jurisdiction through a local company and must meet local capital requirements.

If group capital standards are introduced, and if they allow diversification credit (or otherwise are lower in amount) and assume that capital is fungible, then U.S. companies could be at a competitive disadvantage. For example, if U.S. capital standards are higher than the international standard, then in the United States, both U.S. and international companies would have to hold this higher amount. But outside the United States, these international companies could count this "redundant" amount against their [lower] group capital requirement, which could give them a competitive advantage. Of course, if the international standard is higher, then U.S. companies would have a competitive advantage.

7. **Are you familiar with the process that the IAIS and the Financial Stability Board (FSB) are using to develop the IAIG designation and capital standards? If so,**

    a. *To what extent are the Federal Insurance Office (FIO) and the Federal Reserve obtaining input from a broad range of stakeholders and providing transparency to the public in this process?*

    We do not have enough information to comment on the public consultation activities occurring at the FIO or Federal Reserve.

    b. *What is the level of influence of the United States in the process of developing capital standards within IAIS?*

    At the IAIS, the FIO chairs the Technical Committee and the U.S. has appointments to many of the key committees, including the Executive Committee. But, in the end, the United States has far fewer members on the Executive Committee than, for instance, the European Union. This translates into far fewer votes on major policy decisions.

*****

Thank you for this opportunity to provide our views on global capital standards for inclusion in the GAO's report. If you have any questions or would like to discuss this letter in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Jeffrey S. Schlinsog, MAAA, FSA
Chairperson, Financial Regulatory Task Force
Risk Management and Financial Reporting Council
American Academy of Actuaries