



AMERICAN ACADEMY *of* ACTUARIES

February 25, 2011

Financial Stability Oversight Council
Attn: Lance Auer
1500 Pennsylvania Avenue NW
Washington DC 20220

Re: Authority to Require Supervision and Regulation of Certain Non-Bank Financial Companies
(12 CFR Part 1310)

The Financial Regulatory Reform Task Force (Task Force) of the American Academy of Actuaries¹ is pleased to provide the following comments on the proposed Rule 12 CFR Part 1310 issued by the Financial Stability Oversight Council (Council). Our comments are intended to provide objective advice to the Council as it prepares to carry out its responsibility to identify non-bank financial companies whose business activities or financial distress could pose a threat to the financial stability of the United States.

Overview and Objectives

In order for the Council to develop “criteria that will inform...the Council’s designation of nonbank financial companies under the DFA,” it is critical to establish metrics and procedures to help identify the companies and the activities that could be subject to this additional supervision.

The Task Force comments that follow are offered to provide direction /certain general criteria, to facilitate further discussion and to generate subsequent analysis. We acknowledge that any metrics developed as financial systemic risk indicators are principally an aid to determining companies whose business activities might potentially pose a threat to the nation’s financial stability. For example, a rapid growth of substantial sales in financial products or transactions by a particular company that are highly dependent on borrowing or other financial transactions, may be one potential indicator of possible risk to financial stability.

The Task Force has adhered to certain principles in our examination of such financial risk:

¹ The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public on behalf of 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.

- While the failure of only one company may not present a threat to the financial stability of the United States, there can be a high degree of interconnectedness within the financial services industry due to the assumption of common, correlated risks. Thus, there is the risk of contagion among companies in a common industry or market creating an environment of potentially multiple simultaneous financial losses or failures. Risk metrics should provide discernable/distinguishing information/data to identify where there is a substantial concentration of risks among companies and where a subsequent failure of these non-bank financial companies could adversely impact the financial stability of the United States.
- Both quantitative metrics and an established process for evaluating qualitative considerations and emerging issues are required. The companies that might be vulnerable to financial distress are better identified when their financial risk management practices are evaluated in terms of the potential systemic risk(s) related to their business activities, financial practices and finance operations.
- Metrics used by state and local regulators and credit rating² agencies have measured the financial solvency of companies. The development of appropriate metrics to identify those entities most vulnerable to systemic risks will require additional analyses of the similarities and differences between banks and non-bank financial institutions. Systemic risk as it applies to the insurance industry and other non-bank financial services companies must first be defined before metrics can be developed to serve as an indicator of the development of the risk and to distinguish systemic risk from financial risk.

The metrics and procedures are intended to identify whether the financial distress of these non-bank companies could threaten the financial stability of the United States. For example, with respect to the insurance industry, it will be important to consider if the inability of a company to remain solvent, or if a significant reduction in the capacity of an insurer to assume new risks, is important to the financial stability of the United States. These threats may arise from the financial distress of individual or multiple companies over a short time frame where there is little time to identify, let alone correct, the problems through normal industry mechanisms.

The voluntary withdrawal of a company from a market where it has significant market share should not automatically be considered a systemically risky event. These events may occur as a result of changes in the risk profile of the market such that the risks assumed either cannot be priced or managed effectively. The potential for financial distress at companies which have significant market share in a specific risk class may have systemic relevance. The cessation of risk services could be considered a systemic event when it is attributable to the financial distress of the company and there is the potential that the companies' market share cannot be replaced by

² Nationally Recognized Statistical Rating Organizations

other providers of these risk services and the risk assumed is interconnected in a leveraged fashion into the larger economy.

As to the ability of large insurance companies to meet their existing obligations, it is important to recognize that in addition to reserves being held that are at least as strong as current surrender values, there are existing insurance guaranty funds at the state level intended to minimize the distress to existing customers created by the failure of their company. In addition, the insurance industry has historically demonstrated the ability of other companies to assume the risk from financially distressed companies. As a result, metrics and qualitative processes should also be established to capture the potential for financial distress involving multiple companies which cannot be coped with by existing industry and regulatory mechanisms.

Metrics

The proposed 12 CFR 1310 rule defines the potential for “Spillover” from a firm’s distress to the broader financial system to be based upon size, lack of substitutes, and interconnectedness. The “Vulnerability” of each of these companies to financial distress is measured by leverage, liquidity risk and asset liability mismatch, and existing regulatory scrutiny.

In a real-world application of these definitions to assess risk companies would first be identified based upon their Spillover characteristics, and then for each company, measure its Vulnerability in order to determine the whether each should be subject to additional supervision.

A company identified by any one of these classifications would not in itself mean the company would be subject to additional supervision. Rather it is the extent to which a company falls into multiple Spillover categories and is identified as Vulnerable to financial distress by additional quantitative and qualitative metrics that determines if the company is potentially poses a systemic risk.

Potential Spillover Metrics

The DFA provides for certain considerations to be reflected in identifying systemically risky entities. Risk measures related to market share can be developed that consider the importance of the company and its subsidiaries as: (i) a source of credit of U.S. households, businesses, and state and local governments, (ii) a source of liquidity for the U.S. financial system, and (iii) a source of credit for disadvantaged (e.g., low-income, underserved) communities and the impact the failure of such a company would have on the availability of credit in such communities.

The metrics for the identification of companies having the potential to create Spillover should be developed based on the following factors and illustrative metrics:

1. **Market Share-** the extent to which a non-bank entity dominates a financial market. For insurance this can be developed through observation of individual company market share within one or more of the U.S. insurance industry product lines. The metric to identify

such dominance would be based in part upon assets acquired, market specific premiums, or additional risk exposure, including amount of insurance coverage, which directly relates to market size. The product lines measured will likely be identified qualitatively based upon an assessment of the Spillover impact which includes a lack of substitute companies to assume the risk and the effect that lack of substitute has on the market.

2. **Size and Lack of Substitutes**- the assessment of the Spillover impact will also be identified qualitatively based on size and lack of substitutes. These measurements can be captured by the metrics applicable to large insurance companies with large risk obligations. When multiple failures affect the ability to fulfill existing obligations, there are Spillover implications. Metrics would include those that are: premium-based, asset-based (acquired), liability-based, and face amount of insurance in addition to other metrics depending upon the nature of the risk obligations assumed. It will be necessary to risk-weight the metrics identified to the extent they are developed in aggregate across product lines. The lack of substitutes could occur because of the uniqueness of the obligation or the inability of other companies to assume the breadth of the risks.
3. **Interconnectedness**- the degree/level/extent of interconnectedness can be captured by identifying large insurance companies where its U.S. operations are linked with the operations of affiliated non-insurance financial services providers whether in the United States or abroad. This metric is based on qualitative criteria as it requires a review of the operations of the organization. Interconnectedness can also identify companies providing risk mitigation services (e.g., reinsurance, derivatives investments, etc.) to the insurance industry where the financial distress of these companies could impair the ability of insurers to assume risk.

Potential Vulnerability Metrics

1. **Regulatory Scrutiny**- this is a qualitative metric as it requires an evaluation not only of U.S. functional regulation, but the overlapping regulation for non-insurance financial services companies and foreign entities affiliated with U.S. insurers. The evaluation of existing regulatory scrutiny also includes the preparedness to supervise new and evolving, substantial, and rapidly growing risks.
2. **Quantitative Metrics**- the DFA stipulates initial reliance on data from functional regulators to facilitate the collection of data by the Council. U.S. insurance company regulatory requirements produce a range of financial information including quantitative measures which will be helpful in identifying the Vulnerability of companies. For example:
 - **Concentration**- where concentration relates to the diversification of the company related to its risks and the characteristics of these risks. For example: the number of different product lines and the distribution of products by geography and other risk

classifications. A metric would be based on analysis of the distribution of risks assumed by the company and the characteristics of these risks.

- **Interconnectedness** - the dependence of the company on other financial services companies. The impairment of the company being relied upon will impact the other company. For example: the reliance by an insurance company on reinsurance or the acquisition of derivatives to hedge interest rate risk. Here the metric would be based on indicators of particular risks to which the insurance company is exposed as well as the liquidity risk associated with that exposure.
- **Leverage** - expressed as either the use of debt, use of reinsurance, or low capital ratios. The establishment of capital ratios will need to be done factoring in considerations such as: the time horizon over which required capital is determined, the level of conservatism embedded in the reserves, accounting requirements, etc.
- **Short-term financing** - where funds are needed to support the obligations of the company and the metrics indicate outstanding short-term debt in relation to the obligations and operations being financed.

To illustrate the types of metrics used in the insurance sector, attached³ is an example historically used by functional insurance regulators: Insurance Regulatory Information System (IRIS) Ratios. While no single metric can accomplish regulatory goals, we offer this illustration to demonstrate how one metric might be used, and to discuss the types of measures and tools that will be needed to fully capture the risk profiles of individual companies as well as the systemic risk they may pose. These IRIS ratios were developed as an early warning indicator for the measurement of potential financial insolvency based on past results and the objectives of the functional regulator and were not developed with any consideration for risks related to the financial stability of the United States nor to be used as comparative ranking among companies. They are focused on individual companies rather than on the entire industry or groups of systemically relevant companies. They are not the kind of forward looking analytic that would be needed to manage systemic risk developments.

In addition, to these metrics, others are available, such as the ratios of actual capital to regulatory capital, called the Risk-based Capital (RBC) ratio. It is important to understand that even the current risk based capital ratio measures have many of the same limitations. While there are some elements of early warning measures in the RBC measures, they also are not intended to be used as a comparative ranking between companies and are focused on individual companies.

Based on the objectives of the Council, quantitative and qualitative metrics can be targeted to systemic risk analysis and the potential impact analyzed to determine that the metrics accomplish the objectives.

³ See Attachment 1

3. Qualitative Metrics

- The **evaluation of risk management practices**, particularly as applied by conglomerates where there could be issues related to the extent to which non-insurance financial activities might affect the U.S. insurer or the effectiveness of foreign and domestic/domiciliary regulation. This evaluation includes an analysis of effective stress testing that should be incorporated in the risk management practices. There is also stress testing information available in the documentation developed for individual insurance company regulatory filings related to asset-liability management practices.
- The **monitoring of rapidly expanding, substantial, new risk services and products** developed by insurance companies, and the management of those risks.
- The **extent of financial product guarantees**, beyond the guarantees provided in traditional insurance industry products.

We recognize the importance of the effort required to implement an effective system to identify companies that might threaten the financial stability of the United States. Unique issues relate to systemic risk that the current system of U.S. functional regulation can address, if not resolve. We offer our assistance in tackling these issues and in your efforts to establish a systemic risk management regime for non-bank financial institutions, including the insurance industry. Many of the risks encountered by the non-insurance financial services company are similarly experienced by insurers and as a result have already been addressed by actuaries in their risk management responsibilities.

We hope these comments contribute to your efforts toward reaching your objectives in the rulemaking process. You have our sincerest commitment to be of assistance in completing this important task. If you have any questions, please contact Tina Getachew, the Academy's Senior Analyst for Risk Management and Financial Reporting issues (202-223-8196; Getachew@actuary.org).

Sincerely



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NAIC Insurance Regulatory Information System (IRIS)

The NAIC's **Insurance Regulatory Information System (IRIS)** is an aid in identifying insurers in need of regulatory attention. The statistical phase produces the IRIS ratios: 13 key financial ratios from the NAIC data base, computed from financial information obtained from insurers' statutory annual statements. Each test has a predetermined **normal range**. Insurers with **unusual values** – results outside these ranges – may be subject to additional analysis of their operations and financial condition.

Property/ Casualty IRIS Ratios⁴

A.S. Year 2010

Unusual Values

Ratio	Description	Over	Under
1	Gross Written Premiums ("WP") to Policyholders Surplus (PHS)	900%	--
2	Net WP to PHS	300%	--
3	Change in Writings	33%	-33%
4	Surplus Aid to PHS	15%	--
5	2-Yr Overall Operating Ratio	100%	--
6	Investment Yield	6.5%	3.0%
7	Gross Change in PHS	50%	-10%
8	Net Change in Adjusted PHS	25%	-10%
9	Liabilities to Liquid Assets	105%	--
10	Agents' Balances to PHS	40%	--
11	1-Yr Reserve Development to PHS	20%	--
12	2-Yr Reserve Development to PHS	20%	--
13	Estimated Current Reserve Deficiency to PHS	25%	--

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Life IRIS Ratios⁵

A.S. Year 2010

Unusual Values

Ratio	Description	Over	Under
1	Net Change in Capital & Surplus	50%	-10%
1A	Gross Change in Capital & Surplus	50%	-10%
2	Net Income to Total Income	-	0
3	Commissions & Expenses to Premiums & Deposits	Disc.	--
4	Adequacy of Investment Income	900%	125%
5	Non-Admitted to Admitted Assets	10	-
6	Real Estate & Mortgage Loans to Cash & Inves. Assets	30%	
7	Affiliated Investments to Capital & Surplus	100%	
8	Surplus Relief		--
	Over \$5 million in Capital & Surplus	30%	-99%
	Under \$5 million in Capital & Surplus	10%	-10%
9	Change in Premium	50%	-10%
10	Change in Product Mix	5%	-
11	Change in Asset Mix	5%	-
12	Change in Reserving Ratio	20%	-20%

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