AMERICAN ACADEMY of ACTUARIES

December 16, 2011

Department of the Treasury
Federal Insurance Office
MT 1001
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Notice and request for comment by the Federal Insurance Office (the ''FIO'') regarding its study on how to modernize and improve the system of insurance regulation in the United States.

Dear Director McRaith:

The Financial Regulatory Reform Task Force ("the Task Force") of the American Academy of Actuaries[1] appreciates the opportunity to provide input to the FIO on its study on how to modernize and improve the system of regulation in the United States as mandated by *the Dodd-Frank Wall Street Reform and Consumer Protection Act*.

We have chosen to focus our comments on topics related to areas where the actuarial skill set has unique application to insurance oversight: the regulation of insurance risk and, more specifically, systemic risk. As explained in more detail later, we take a more comprehensive view of systemic risk which includes the inability to procure insurance coverage. Our comments reflect not only our experience with the current regulatory system, but also reflect our understanding of regulatory improvements already underway. Our comments address issues arising from what we consider gaps currently existing (and in some ways inherent) in the financial regulatory processes, in whatever jurisdictions they might exist.

We have included two appendices further discussing these points. The first discusses systemic risk as it might apply to the insurance sector, some of whose risks are different than those in non-insurance financial services industries. The second explores potential gaps in the nature of insurance and financial regulation, with examples, more thoroughly explored than in the main body of this letter.

Regulators, including the International Association of Insurance Supervisors (IAIS) are developing ways to expand their capacities to better anticipate and regulate emerging patterns of risks before the point at which adverse results of those risks can overwhelm insurance entities, the insurance sector or the financial services sector. Regulatory expertise is needed to oversee, track, and remain proficient with the complexities of adaptive/evolving financial risk. These regulatory improvements will benefit from coordination at state, federal and international levels. We believe the FIO, Financial Stability Oversight Council, (FSOC), the Office of Financial

[1] The American Academy of Actuaries is a 17,000-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.

Research (OFR), as well as functional regulators, each have a critical role in developing the processes necessary to fully address emerging systemic risk. It will be critical that all those involved in the regulatory process coordinate their oversight and regulation of the financial sector to accomplish that goal.

Is coordination critical?

1. It is critical that regulators of the insurance sector coordinate with regulators of banking institutions and other financial services entities to address, across the sectors, mutual challenges such as those posed by reinsurance contracts, international treaties, interrelated counterparties and systemic risks. This coordination needs to occur across financial service entities which have different business models, risk exposures, risk management options and safeguards so that gaps in regulatory oversight and controls can be identified and addressed.
2. Without coordination across regulatory jurisdictions, the potential exists for partial or complete lack of regulation of some financial market risks.
3. Periodic evaluations of the costs and effectiveness of expanded regulatory oversight are crucial to ensuring an effective regulatory system. Coordination of government regulatory resources at all levels will be a priority.
4. Coordination does not necessarily require uniform accounting and capital regimes across all national boundaries and/or financial sectors. But effective coordination does require an agreed-to regulatory framework to facilitate communication and a process to manage diversity effectively and discerningly.
5. Given that regulatory authorities will always have some differences, coordination is needed to manage across jurisdictions so that regulatory differences do not also create the opportunity for insurance entities to choose regulators with the weakest standards and oversight process to become the regulator of choice in a way that might threaten the larger system.
6. Without coordination at the local, national and international levels, companies may be presented with conflicting and duplicative regulatory priorities and demands. Similarly, regulators may be charged with reporting requirements that do not lead to a meaningful and productive use of regulatory management responses.

In the following paragraphs, we offer three observations and a practical suggestion on how to approach this needed coordination.

Observation #1: The financial strength of the overall US insurance industry was largely left intact in the face of the most recent financial crisis largely because of the sound foundation of the insurance business practices and the state insurance regulatory system. A successful insurance entity business model relies on sound risk management practices while effective functional regulation emphasizes the preservation of the financial strength needed to fund insurance guarantees through capital and reserve requirements. In addition, the current regulatory system provides an effective resolution process via its rehabilitation and guaranty fund mechanisms in the event a company becomes insolvent. While state-adopted regulatory capital requirements

(RBC) are an important risk management tool used by regulators, they were and are not intended to be the complete solution. For further background on the risk-based capital tools and framework that support the US insurance industry solvency system, we refer you to the following report prepared earlier this year for the National Association of Insurance Commissioners (NAIC) (http://actuary.org/pdf/life/American_Academy_of_Actuaries_SMI_RBC-Report.pdf). In addition, we recommend reviewing the Academy comments on the NAIC Solvency Modernization Initiative (http://www.actuary.org/pdf/finreport/naic_0209.pdf).

There are other important factors reinforcing the insurance sector's ability to withstand the impact of financial crises such as that experienced in 2008, including:

a. Less unexpected liquidity demands than in other financial entities (e.g., banks), due to the coverage/event trigger, settlement negotiations, and the longer term nature of liabilities that are prevalent in the insurance industry;

b. Many liabilities are either not liquid or are liquid only after payments of a surrender charge;

c. Minimal reliance on leverage;

d. Disciplined insurer practices surrounding, asset liability management reinforced by regulatory oversight;

e. Provisions for the marketplace to assume the liabilities of a failed insurance company with, minimal, if any, loss to policyholders[2]; and

f. Different and more gradual resolution processes in the event of an insolvency (as a result of the longer time horizon of liabilities cited above).

Observation #2: Notwithstanding the above factors, generally, the exception of the American International Group, Inc. (AIG) liquidity crisis in 2008 leads to the next point.

The basis for any additional prudential regulation related to systemically important financial institutions with insurance affiliates needs to be an understanding of the <u>specific</u> underlying risks of individual companies deemed to be systemically important and the risk management processes of the group to which it belongs, rather than solely based on a simplified formula common to all companies[3].

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[2] As a matter of interest, since surviving insurance companies fund the losses of failed companies, there is an active dialogue in the industry that helps flag emerging risk issues.

[3] Even adherence to required reporting and capital requirements can nevertheless contribute to systemic buildup. Firms that only manage to minimize required capital could buy assets that are either valued as "less risky" in today's market or that provide more yield for the same perceived risk rating. In either case, when the market's appetite for

The regulatory process of managing the complex risks of business models that vary across and within various financial institutions needs to be dynamic[4]. It is not enough to simply verify compliance with laws and reporting requirements. Regulators must also identify (and may likely be expected to mitigate) future systemic risk. Forward-looking regulatory tools and processes will be necessary. As an example, risk-focused examinations represent a paradigm shift in regulatory focus from "box checking" to one that includes tools such as regulatory audits which can be focused on the risk areas of unique importance for an individual insurer. Similar tools and processes are needed to identify when there are changes to the business model of the company and if those changes have risk implications beyond just those to the company. In other words, tools to address the question of "when does the business model change from one that is managing risk of the firm to one that is creating and amplifying risk for other firms or the general economy?"

Observation #3: An effective and coordinated regulatory system will need to be able to efficiently do the following:

1) Implement a process to identify emerging risks and how they might be measured. This includes assessing new and emerging ways that companies are compensated to assume risk on behalf of another party as well as monitor substantial evolving market and industry trends that may increase the systemic risk potential of the US insurance industry.
2) Assess the effectiveness of the regulatory process in mitigating systemic risk, including its need for increased resources, information, capabilities or new laws and regulations to respond to emerging trends.
3) Coordinate monitoring of insurance companies who are members of systemically important financial groups in multiple supervisory jurisdictions where gaps in regulation may allow for the accumulation of systemic risk.

Collectively, the above observations as applied in the modernization of insurance regulation ideally should effect the following, without unnecessarily increasing (or with minimal) costs to consumers, insurers, and taxpayers.

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certain risks changes, the overexposure to what used to be considered either safe or higher yielding assets may lead to the market having a fire sale as firms shift to new "less risky" or higher yielding assets.

[4] By business model we mean the service that is actually being sold and the manner by which it is managed. Business models must consider, for example, different accounting standards, time horizons of the obligation, and legal obligations between the entity and its customers. At the heart the enterprise of insurance is the selling of a promise managed through the pooling of independent risks backed by reserves and capital. Banks may sell a promise of deposits managed through much lower reserve and capital requirements, but which are also backed by the US government. The business model is the way in which the company tells its shareholders it is creating value. Banks typically create value by leveraging their deposits into loans. A major challenge to regulating AIG occurred when it began expanding its original insurance business model to reach out and begin competing with a financial services business model. There was no framework for coordinating and assessing the different metrics and risk indicators to assess the long term sustainability of the broader enterprise.

1. Identify systemically important financial groups and contribute to developing additional prudential regulation for these entities across state, federal, and international jurisdictions.
2. Manage prudential regulation of systemically important entities for which different capital and risk management processes may be in place due to differing business models and risk exposures.
3. Monitor substantive trends in the risk assumption and business practices of insurance companies, particularly common adherence to risky behavior (e.g., insuring those new risks without sufficient or credible historical experience).
4. Monitor non-insurance financial service entities offering products that assume insurance risk (insurance risk is further discussed in the Systemic Risk Appendix to this letter) not subject to functional insurance regulation, including those that secure insurance liabilities, assume longevity and mortality risk, guarantee investment performance, function as surety for financial obligations, offer unsecured catastrophe bonds, or serve as counterparties in swaps of insurance risk related cash flows.
5. Grow the capacity of existing functional regulation of insurance to support these efforts with respect to understanding the assumption of substantial new risks and financial management practices. This will enable regulators to supervise based on each company's unique characteristics and risks even when complex methodologies and risk management practices are being adopted. Functional regulators will need to train and/or acquire staff or consulting expertise to address the unique characteristics, methodologies, and risk management practices of each company.
6. Prevent intra-group regulatory arbitrage so that the capital and risk management requirements to assume the same or similar risks do not vary with the legal form of the entity.

Resources and Practical Tools to Meet Requirements for Risk Oversight

As stated above, coordination is critical so that all regulators can effectively leverage (and coordinate), with the authority of federal regulators coming on-line, the extensive tools and staff experience which already exist at the state level and within professional associations, to manage emerging insurance and financial risk. Current tools and processes already in place include:

1. State Regulators' Risk-Focused Examinations - Effective in 2010, the exam process starts by a company identifying and quantifying all of its risk exposures, then determining which risks are mitigated and how, concluding with a summary of the net risk position of the company. This facilitates the focused examination of the most critical areas of the enterprise. Efforts are ongoing to assess and improve this process so that exams are both more effective in informing the regulator as to the actual risk exposures of the company and better ensure an efficient (cost-effective) review for all concerned.

2. Coordinated Cross/Multi-State Financial Analysis, such as the NAIC's Financial Analysis Working Group (FAWG) - A collaborative process of state regulators that combines quantitative data from financial statements and confidential risk exams with qualitative processes to serve as an early warning system is another tool for companies that may require

regulatory intervention. As this is a confidential process, the Task Force cannot comment on its specific details. However, its publicly available charges include:

- Analyze nationally significant insurers and groups that exhibit characteristics of trending toward or being financially troubled; and determine if appropriate action is being taken.
- Interact with domiciliary regulators and lead states to assist and advise as to what might be the most appropriate regulatory strategies, methods and action(s).
- Support, encourage, promote and coordinate multi-state efforts in addressing solvency problems, including identifying adverse industry trends.

This process makes lead states accountable for their oversight to the other states.

3. Actuarial Memorandum – A confidential report required to be filed with a life insurance company's Board of Directors and with regulators in conjunction with each annual statement documenting the modeling methods used and the risks assessed to determine if, for life company reserves, additional reserves above the minimum standards are needed

In addition, the following emerging processes are being actively developed by both domestic and foreign regulators:

1. Supervisory Colleges - for complex, international organizations to coordinate between national regulators.

2. "ComFrame" – A common framework for internationally active insurance groups (IAIGs). This is a project of the IAIS to bring a more global and integrated approach for regulating complex international firms. It is intended to include the effective regulatory use and application of stress testing for IAIGs.

3. Own Risk and Solvency Assessment (ORSA) - The ORSA requirement is included as part of Insurance Core Principle 16 of the IAIS. The goals of the ORSA as currently defined in the NAIC model draft are:

   1) To foster an effective level of enterprise risk management (ERM) at all insurers, through which each insurer identifies and quantifies its material and relevant risks, using techniques that are appropriate to the nature, scale and complexity of the insurer's risks, in a manner that is adequate to support risk and capital decisions; and

   2) To provide a group-level perspective on risk and capital, as a supplement to the existing legal entity view[5]

   Since an ORSA takes a group view encompassing both insurance and non-insurance activity, it may provide insights that otherwise might not be available to regulators. A collective review of ORSAs could increase understanding of substantial key risks and their trends and facilitate the work of regulators in spotting new, emerging, substantial risks.

[5] From the December 2011 version of the NAIC Draft ORSA Model Act

4. Stress Testing. The actuarial profession's leadership has engaged with thought leaders at the International Monetary Fund (IMF), to develop useful methodologies for developing and applying stress tests. This project will support the necessary regulatory cooperation and insight to oversee insurance companies, particularly within the context of financial services conglomerates, both domestic and foreign. As our work in this area proceeds, we can provide you with updates.

Collaboration is necessary, among the FIO, OFR, FIO, and with state-based entities such as the NAIC) and the National Conference of Insurance Legislators (NCOIL), to facilitate development of appropriate processes using the above tools. For example, a collective review of ORSAs might help regulators spot new, emerging risks and also better judge which established risks merit the highest regulatory attention on both a local and world-wide basis.

We hope these comments, and those included in the appendices that accompany them, help your efforts going forward in addressing insurance regulation issues in your reports to Congress. We would be pleased to answer any questions you have related to this letter. 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)

<u>Appendix A - Systemic Risk</u>

As with much of the broader financial services sectors, insurance enterprises can become more complex, spurred in part by the introduction of increasingly innovative products, the assumption of highly complex risks, the prevalence of diversified financial services groups and availability of some risk assumption services that are not regulated as insurance, and therefore not in a manner consistent with insurance regulation. The developing risks arising from such changes may not be accurately assessed or appropriately regulated under current functional or federal regulatory systems and these risks could ultimately become a source of systemic risk.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* did not provide a specific definition of systemic risk. As the Federal Insurance Office (FIO) report, as required by the Act, is intended to address the modernization of insurance regulation with respect to systemic risk, among many other areas of insurance oversight and regulation, it is necessary to define systemic risk as it applies to the insurance industry. The Task Force offers a definition of *systemic risk* to spur this discussion as the following: "Systemic risk is the risk of disruption to the capacity of the insurance industry to assume risk and pay claims, arising within the financial services industry as a result of insurance company activities or within the insurance industry as a result of non-insurance financial services activities, resulting in serious negative consequences for the real economy."[6] The Task Force has been evaluating potential gaps in functional regulation against this systemic risk framework and against its expectation of future developments which could render whatever regulation exists to mitigate systemic risk less effective unless efforts are made to adapt it.

As with any dynamic market, evolving practices or trends in the insurance industry may result in the potential for systemic risk that may not be effectively captured by current regulatory modernization efforts. The Task Force has identified several potential drivers, such as:

- Globalization of the insurance industry
- Insurance companies that are affiliated with/owned by non-insurance financial services companies (recognizing that this was more prevalent in the past decade)
- Activities of non-insurance financial services groups in the assumption of insurance risk
- Uneven existing regulations in an increasingly complex environment

Insurance company risks with the potential to develop systemic implications can be grouped into two main categories: risks related to the investment activities of insurance companies and, risks solely related to the assumption of insurance risk. These risks do not differ based on corporate ownership of the insurance company. However, risks related to the investment activities of non-insurance financial service groups may heighten the risks to affiliate insurance companies (e.g., AIG), particularly if there is overlapping supervision resulting in lack of clarity of regulatory responsibility. From an actuarial perspective, the focus of US functional regulation is the preservation of the insurance company affiliate of a failed financial services group. If a financial group fails, an insurance affiliate may be financially impacted by intra-group transactions or

[6] While the Financial Stability Oversight Council has made strides to define systemically important non-bank entities, it is important that the FIO develop a working definition to suit their charge of overseeing the unique characteristics of the insurance sector, and work with the FSOC to implement that definition.

even suffer an impaired reputation as a result of its relationship with the failed group such that it cannot effectively conduct its ongoing activity of new risk assumption services.

Risks to an insurer from the activities of non-insurance members of a financial services group are a current development focus of state and international regulatory developments.

Appendix B - Potential Regulatory Gaps

The Task Force has categorized potential regulatory gaps that should be addressed to more effectively minimize or manage systemic risk in two ways (both of which could result in a withdrawal of insurance coverage):

- ***Reliance Gaps*** - Reliance by regulators as to the extent of regulation undertaken by another regulator. This relates to situations where insurance companies are part of financial service groups subject to federal regulation or where financial products assume risk that are not regulated by functional insurance regulation. It also may arise where there is ineffective and inconsistent communication and regulation among functional regulators.
- ***Regulatory Arbitrage Gaps*** - International ownership or foreign reinsurance of US insurance companies and the extent to which there are regulatory differences between the US and foreign regulator.

Reliance Gaps

Functional insurance regulation relies upon a system of communication and coordination among regulators, at the state, federal, and international levels. A break-down in this system creates a reliance gap.

National State-Based Insurance Regulatory System

U.S. insurance financial solvency regulation has evolved under a system of model laws adopted by a national organization, the National Association of Insurance Commissioners ("NAIC"), the consideration and adoption of these laws by the fifty states (and US territories), and a system of financial examinations where multiple jurisdictions rely upon a lead state examiner to achieve their supervisory objectives. The NAIC accreditation system audits the quality of state financial regulation and currently the purpose of the NAIC's Financial Analysis Working Group (FAWG) is to evaluate issues of nationally significant insurers and the effectiveness of member state functional regulators. Financial reviews of each insurer are led by the functional regulator of the state of domicile, while other states monitor insurers and may take regulatory action as they see appropriate (e.g., revoke an insurer's license to do business in their state based on the findings of individual states). These findings are largely not reported in the public domain, although the regulatory actions may be.

This system has been effective in mitigating systemic risk among insurers to date, however, the current insurance regulatory system could be improved by strengthening the level of supervision directed at the industry in aggregate to monitor and address emerging trends and risks. A system that utilizes multiple functional insurance regulators would be able to identify large or emerging risks and should identify and take action toward companies in hazardous financial condition.

Regulation of Financial Groups

When insurance companies are owned by non-insurance financial services or foreign owned or controlled companies, communication and coordination become even more important.

Should there be miscommunication or misperception among regulators, a reliance gap could exist.

Insurance group supervision in the U.S. falls under the authority of the insurance holding company laws and regulations of each state. The 2008 financial crisis highlighted the need for more regulatory attention to risks across the group that could impact the insurance company through its interconnectedness with other affiliates. As a result of efforts in the NAIC Solvency Modernization Initiative, the NAIC adopted changes to the insurance holding company model laws to incorporate the supervision of enterprise risks under functional regulation.

A reliance gap could also emerge if state, federal, and international regulators are unable to fulfill increased demand for technical capabilities to monitor risks across companies and regulatory environments as financial oversight of these groups is being developed.

Examples of gaps that can arise as a result of a regulatory mismatch over financial conglomerates and/or foreign owned insurance providers include the following.

- *Reinsurance*
  Reinsurance companies are significant providers of risk mitigation services to the insurance industry. Functional regulators should be knowledgeable about the financial strength of counterparties to these reinsurance transactions. For example, the large international reinsurance market requires US regulators to maintain familiarity with regulations from other countries to assess the financial strength of current reinsurers. Also, differences exist among states regarding credit for reinsurance provided on financial statements. As reinsurers provide capacity to insurers to assume risk, in markets with major risk concentration, any substantial reduction in the capacity of one or more reinsurers due to financial weakness may impair the capacity of the insurance industry to assume insurance risk.

- *Transactions with other Companies within a Group*
  When insurance companies are part of financial services groups, the regulation of the non-insurance financial services company may not necessarily be sufficient to avoid impairing the financial strength of the insurer, meaning a lessened ability to offer insurance coverage. Functional insurance regulations are in place to monitor transactions between affiliates. However, to the extent the insurance functional regulator does not have authority over the non-insurance financial transactions (where there is instead federal oversight), there is inconsistent supervision among functional regulators of these transactions and a negative financial condition and/or damaged reputation of the insurance company could be impaired to the point of limiting its ability to conduct ongoing operations. Thus, an insurance company or group of insurance companies of sufficient size, which fails to continue offering coverage as a result of these affiliations, may generate systemic risk as a result of the reduced risk assumption capacity available to consumers and businesses.

The financial crisis of conglomerate AIG is seen by some as an endemic of the financial crisis although it is widely accepted that the AIG insurance subsidiaries remained financially strong. The Task Force credits the strength of these insurance companies to the insurance industry business model reinforced through their applicable functional regulation. Nevertheless, it should be recognized that the AIG case study demonstrates a gap in non-insurance regulation as a result of the lack of supervision of the financial strength of the entire financial services group.

Risk Assumption Products Inconsistently Regulated
Different products for the same insured risks may be inconsistently regulated if financial services providers fall under different regulations. For example, mortgage insurance and credit default swaps have both provided protection against the risk of default in the repayment of mortgage obligations. However, mortgage insurers are regulated by state insurance regulators who require that specific liabilities be established for this product and capital be established for these insurers. Providers of credit default swaps are regulated by the Commodities Futures Trading Commission (CFTC). The two regulators have a different view of the risks of these transactions.

Summary of Reliance Gaps
From the perspective of the regulation of systemic risk, reliance gaps can develop from:

- Ineffective communication among functional regulators, including lack of awareness of regulations and practices across regulatory and geographic boundaries. It should be recognized, however that ineffective communication can similarly be a factor for single-entity functional regulation if it lacks effective governance protocols.

- Inconsistent regulation among functional regulators, including the rigor and amount of resources deployed in regulation, including the skills and training of regulatory staff

- Standards and oversight rules adopted for systemic risk which are inconsistent with insurance functional regulatory goals

- Ineffective supervision of risk management practices of systemically important financial services groups which include one or more insurance companies

Though codification of model laws and regulations did much to standardize state insurance financial regulation, the structure of a fifty state regulatory system could allow for one or more of these potential gaps (e.g., difference in laws and regulations among the jurisdictions). A well-established method for filling these gaps requires there to be in place an effective regulatory system which communicates among all regulators and provides the technical support to supervise complicated structures.

Regulatory Arbitrage Gaps
Regulatory arbitrage exists where a company elects a jurisdiction in which to do business or base operations where the regulation is considered to be either less prudent, including lower capital requirements, and/or there is a culture of weaker risk assessments. Such incentive

has been cited where some insured entities leave a regulated marketplace and offer insurance through non-regulated or less regulated markets (e.g., captive, off-shore or self-insurance markets). These markets do not require the protections or safeguards built into the state insurance regulatory system, such as guaranty funds, which secure the vast majority of insurance obligations, and capital and surplus requirements. Prior approval rate regulations, declinations required from approved markets in order to access surplus markets, and multiple licensing and tax remittance laws are a few examples of regulations that have influenced companies toward these alternative markets. Systemic risk accumulation could escape adequate scrutiny to the extent a substantial part of an insurance market is not regulated by the state insurance functional regulatory system.

Based on current US insurance regulations, from an actuarial perspective, the effectiveness of regulation to mitigate the systemic risk of the potential withdrawal of insurance coverage can be compromised by the following potential developments:

1. Substantial or sudden changes in the levels and concentration of risks assumed by very large insurance companies or groups of companies;
2. Increasing complexity required in risk management processes to monitor complex financial service organizations, and delay in developing regulatory expertise to monitor them;
3. Consolidation of risk transfer service providers, such as reinsurers and counterparties to hedging transactions, such that their scarcity may limit the financial effectiveness of insurers' risk diversification efforts; and
4. Substantial or sudden expansion and concentration of new and evolving risks for which the current insurance regulatory system is not prepared to effectively monitor and oversee.