AMERICAN ACADEMY *of* ACTUARIES

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

The Financial Regulatory Reform Task Force (Task Force) of the American Academy of Actuaries[1] is pleased to provide the following comments on the Proposed Rule 12 CFR Part 1310: *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* issued by the Financial Stability Oversight Council ("Council").

In prior comments to the Council (February 25 and June 24, 2011), the Task Force provided initial actuarial perspectives on the draft rule and described potential metrics to aid in the implementation of this Rule. In this letter we provide the Council further work done to define terms related to systemically important non-bank financial institutions. We also include findings from ongoing actuarial discussions occurring within the US profession, as well as internationally, regarding the processes and metrics to be employed to identify such companies or entities as identified by the proposed rule. While our comments focus on the insurance industry, they can be extended to apply to other non-insurance financial services entities.

Overview and Objectives

We have grouped our commentary into three sections

- Definitions and Criteria
- Stages of Review
- Metrics

Our conclusions and observations are summarized as follows:

Given the nature of the regulatory process under the proposed rule (i.e., identification of systemically important financial institutions) it is important to recognize this will require different and more advanced regulatory tools and processes than currently exist. As actuaries we are risk assessors and risk managers. Through the American Academy of Actuaries, whose mission includes serving the public interest, we have been discussing what processes are needed for regulators to address this issue.

A fairly obvious step is to accumulate and examine data over time and not simply as it exists today, at one point in time. The National Association of Insurance Commissioners (NAIC) for the past several years, with input from a wide cross-section of the insurance sector, including

[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.

actuaries, has been developing a new requirement that large US insurers annually conduct their "own risk and solvency assessment (ORSA)" That initiative is nearing the final stages of the NAIC's consideration for adoption.

The goals of the ORSA are:
1) To foster an effective level of enterprise risk management 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[2].

Since ORSAs will also take a group view of risk, encompassing both insurance and non-insurance activities, they may provide insights that otherwise might not be available (and, heretofore has not been widely accessible) to regulators. From the companies' perspective, there has been a desire expressed that their ORSAs should remain, to the greatest extent possible, management's own assessment of their risk landscape, with minimum regulatory prescription of risk categories, scenarios or methods.

From a regulatory oversight perspective, a collective review of ORSAs along with other sources of data and information could help the Council identify substantial new and emerging risks, and also better assess which risks might rise to the level of systemic importance.

The Task Force recognizes that, where a company provides a critical service or function there may be a potential systemic risk should it withdraw while under financial distress when there are no substitutes. However, the designation of a company for further scrutiny based solely on the basis of no current substitutes upon withdrawal of a critical service/product is inappropriate. In most such cases, other companies will step in and provide the service if it is possible to do so on a commercial basis.

However, changes in the underlying insured risk coverage (due to certain legislative or regulatory mandates, legal decisions, or other changes stemming from the riskiness of the underlying insured event) may result in all companies choosing not to provide risk assumption services as imprudent in order to avoid financial distress. Such events could ultimately generate systemic risk.

For such cases it might be most appropriate for the Council to provide official input (either directly from the Council or another entity, such as, the Federal Insurance Office, or the Office of Financial Research) into relevant legislative or regulatory processes so that public policy with insurance market impact is structured to allow financially prudent coverage to be provided by the insurance marketplace. If, in this process it is found that the potential for losses is too large there may need to be an evaluation of viable alternative approaches to the delivery of the service, including government sponsored programs such as those that exist for terrorism and flood risk.

[2] From the December 15, 2011 version of the NAIC Draft ORSA Model Law

The Task Force agrees that the 3-stage process being contemplated provides clarity as to the methodology of identifying systemically risky non-bank financial companies.

a. *Stage I* provides specificity to help companies know whether they meet the initial screening criteria.

b. The use of metrics and other information either available to the public or through the regulatory system for *Stage II* will mitigate unnecessary work for the identified insurance companies.

c. The interaction with companies in *Stage III* in order to analyze the unique qualitative and quantitative characteristics of the company before drawing final conclusions is appropriate and essential.

It would be concerning if the only screening process were to be the application of *Stage I* metrics across the financial services industry due to the heterogeneous nature of the industry. This would be particularly true for the insurance sector where the risks are different not only from other segments of the financial services sector, but between segments of the insurance industry itself. For example, the liquidity characteristics of the insurance industry are more orderly and predictable than the remainder of the financial services sector. Accordingly, it is also important that *Stages II and III* metrics capture the unique risk of each member of a financial services group when consolidating heterogeneous operations.

The level of the Stage I thresholds was tested by Treasury against recent experience from the prior crisis to determine if the relevant companies would have been identified. Since the most critical future risks may differ from those that underlay the crisis, it is not clear whether this process will effectively capture systemically relevant companies that become exposed to material new risks. We recommend that the Council adopt a regulatory process to make the establishment of *Stage I* thresholds more forward looking so as to identify on an ongoing basis trends in new and emerging, material risks and the magnitude of risk accumulation by type of risk, and adjust the thresholds accordingly.

For application to the insurance sector, the development of specific metrics and stress tests to be applied during the 3-stage process requires a deep understanding of the financial management process and risk assumption services applicable to insurance companies, particularly within the context of financial services conglomerates, both domestic and foreign.

The use of the helpful information coming from sources such as the new ORSAs may be useful for developing such an understanding. For example, the process of measuring systemic risk should be performed at both a company-specific and industry levels. The data from an ORSA may allow the Council (and a broader array of functional and systemic regulators who oversee aspects of the insurance sector) to identify risks across the industry that may not be systemically important at the company level but are deemed risky from an industry perspective. This may allow for monitoring industry-wide accumulation of risks to determine the extent to which accumulation of these risks pose a systemic threat.

The definitions or terminology in the Notice of Proposed Rulemaking, such as "material financial distress" and "pose a threat to the financial stability of the United States" as stated provide useful guidance on the process to be applied in identifying systemically risky non-bank financial services companies. However, adding quantitative guidance to these definitions would provide additional clarity to these definitions. Such guidelines would reflect the risk which may be absorbed by these companies in relation to their capital or other indices of risk tolerance. Thus it is necessary to:

a. Identify the activities of the insurance industry whose failure would pose a threat to the financial stability of the United States.

b. Develop quantitative criteria to determine if thresholds have been attained either by an individual insurance company or by a group of companies.
   In our prior submission[3] we provide examples of metrics to help identify companies that have attained a level of market share which would pose a threat to financial stability as a result of financial distress.

<u>Definitions and Criteria</u>

In this section we comment upon certain definitions and criteria in the proposed rule and their potential implications for the insurance industry.

The proposed rule identifies the *impairment of financial intermediation,* the *impairment of financial function*, and the *failure to provide critical functions* and services as key threats to the financial stability of the United States.

The failure of financial intermediation relates to the impact of the failure of a financial services company acting as a counterparty to other financial institutions and the adverse impact of this failure on its counterparties.

The activities of individual insurance companies as counterparties to other financial institutions are not of sufficient size, concentration and interconnectedness to impact the financial stability of the United States. We recognize that there is still an open question on whether and how reinsurers might be systemically significant in this context.

This observation is derived from 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, as 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, asset adequacy testing, and the distressed company rehabilitation process under current functional regulation, forced asset sales resulting from a mandated, liquidation have rarely occurred. The longer time horizon

[3] http://www.actuary.org/pdf/finreport/Academy_Metrics_Letter.pdf

for insurance liquidity allows for tools beyond additional capital to be used to address systemic issues.

An insurance company is no longer willing or able to provide critical functions or services that is relied upon by market participants and for which there are no ready substitutes.

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 risk assumption service(s) cannot be either priced or managed effectively. For example, there could be unintended consequences of a government mandate that may significantly change the characteristics of a risk assumption service. 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 would reasonably not continue to provide a risk assumption service regardless of its importance. The public policy focus should be on the changes in the risk profile of the coverage which changed the financial soundness of the coverage. In fact, this focus is already required where regulators are expected to ensure a viable market.

However, the potential systemic consequences of a cessation of critical risk assumption services under financial distress 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. Thus, only those companies providing critical functions or services that are vulnerable to financial failure would be considered systemically risky. In most instances in the past, however, replacements have generally surfaced within a reasonable period of time, such as after Hurricane Andrew in 1992 when a number of new start-ups assumed the risks of companies exiting the affected market.

Stages of Review

There are several potential indicators of evolving risk that can only be identified by looking at changes over time.

One potential indicator is the trend in financial metrics related to a risk assumption service, particularly as it relates to new emerging risks. For this issue, we recommend adding to *Stage 2* trend analysis based on appropriate metrics since financial metrics limited to a point in time will not provide sufficient information to capture some companies for further review in *Stage 3*.

A second potential indicator is to identify new product lines and/or changes in a business model. American International Group (AIG) "diversified" from just offering insurance to offering more financially risky products. A company's ORSA could be utilized to identify both current and projected expansion of the risk profile.

As the insurance industry is overseen by a well established functional regulatory system, including distressed company rehabilitation provisions, and state guaranty funds that pay claims in the event of failures, the *Stage 2* analysis should focus on the interconnectedness within a financial services conglomerate of the insurance company with its other financial service affiliates as it relates to the ease of deployment of capital and intra group transactions. We recommend the effort at this stage should also capture metrics related to the interconnectedness of the US insurance company with non-US insurance companies and other financial services affiliates. As *Stage 2* would include a screening to determine if there is a lack of substitutes for a company's market share of the risk assumption service, there are a number of terms which need to be defined:

- The criteria to determine a *dominant market share* position
- The criteria to determine *systemically important risk assumption services*
- The criteria to determine if there exists *capacity to replace a failed provider of these critical functions and risk assumption services*

With respect to the *Stage 3* review, there may be certain changes in the financial/economic environment which will stress the non-insurance elements of a financial services group which do not stress the insurance elements and vice versa. Therefore, these potential non-overlapping stress tests need to be applied to all elements to assess the co-variance impact so that the Council can identify the interrelationship of risks among the companies of a group under various stressed conditions.

Metrics

As referenced above, we continue to examine the direction the Council is taking on an appropriate methodology. With the current proposed rule, we have three comments.

Our understanding of the proposed rule is, in determining the level of the Stage 1 threshold metrics, the Council considered the extent to which the metrics proposed would have identified financial services companies that developed systemic risk in the most recent financial crisis. While this approach is helpful, it is not forward looking. It does not capture emerging risk assumption services unless they were already a key factor in the last financial crisis. In order to respond to market trends, financial services companies need to continually develop new risk management services. For this reason it is recognized by insurers that an important preliminary indicator of potential substantial emerging risks will be through trend analysis of substantial changes in identified indicators (e.g., new premium written, asset quality, distribution of liabilities among product lines, etc).

The Task Force recognizes the necessity for the Council to oversee the industry and, as provided in the proposed rule, to develop over time evolving *Stage I* metrics and processes that are appropriate to capturing emerging industry risks. In our prior comments filed June 24, 2011, we suggested certain metrics which should provide guidance to you in developing this list. The nature of the risk assumption services provided by the insurance industry is very different from other non-bank financial services companies. Since the *Stage 1* metrics appear to be more applicable to non-insurance financial services companies, these metrics may only identify insurance companies that are affiliated with a larger financial services group. This may be an appropriate conclusion, at this time, since the industry is not currently systemically risky.[4] However, the *Stage 2* and *Stage 3* process needs to be able to identify possible future changes in an insurer business model and whether that model is being widely used across the industry.

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[4] Nor has there been historical experience to demonstrate that the industry is systemically risky.

We are concerned with the following language contained in the proposed rule with respect to the *Stage 1* process: "…the Council may, in limited cases, initially evaluate nonbank financial companies in *Stage 1* based on other firm-specific qualitative or quantitative factors, such as substitutability and existing regulatory scrutiny." This language is very general and deviates from the intent of the use of generally available and public data for the *Stage 1* metrics. This broad language creates uncertainty as to whether a specific company will be targeted for the further *Stage 2* review.

With respect to the specific *Stage 1* metrics proposed we have two general comments:

1. Insurance industry statutory reporting, the basis for the analysis of the financial strength of the company, is very different from the accounting for the remainder of the financial services industry. A reasoned approach to the consolidation of insurance and non-insurance financial service values would be to use the statutory basis for the insurance industry. For example the consolidation of assets among financial service affiliates in a group to compare against the fifty billion dollar threshold should be based on statutory financial assets for the insurance affiliate.
2. Not only are the risks very different between the insurance sector and the remainder of the financial services sector but risks assumed by insurers vary among the different types of insurance companies. We view it as very important that the process allow for the differences in the risks assumed among financial services companies to effectively evaluate the different financial services groups.

It is evident that research will be needed to make the process effective with respect to the range of metrics developed for *Stage 2 and 3* and the stress tests to be employed *in Stage 3*. We recognize that the Council, Office of Financial Research, and Federal Insurance Office will require assistance and input in this effort and the Task Force, in conjunction with other leading actuarial professional groups is working to provide assistance in identifying relevant metrics, the method for the analysis of the companies, including the development of risk management processes and the design of research studies to monitor the industry on an ongoing basis for emerging risks.

We hope these comments help your efforts in the rulemaking process. 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).