AMERICAN ACADEMY *of* ACTUARIES

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Roundtable: States and the FIO: What will the FIO Report Mean for U.S. Insurance Regulation?

The American Academy of Actuaries'[1] Financial Regulatory Reform Task Force submitted comments[2] on December 16, 2011 to the Federal Insurance Office (FIO) regarding its statutorily-required report to Congress on modernizing and improving the system of insurance regulation and oversight in the United States. The Task Force focused on areas where the actuarial skill set has unique application to insurance oversight: the regulation of insurance risk and, more specifically, systemic risk. This presentation summarizes the Task Force's views on modernization as expressed to the FIO, with particular emphasis on modernizing the regulation of insurance:

- 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 risk-focused management practices and the state insurance regulatory system. A successful business model for an insurance entity relies on sound risk management practices operating in tandem with effective functional regulation. Effective functional regulation should emphasize the preservation of insurers' financial strength needed to fund insurance guarantees through capital and reserve requirements. The importance of insurers focusing on risk management while regulators focus on the preservation of financial strength should extend to all financial service providers.

- However, as with many dynamic markets, evolving practices or trends in the insurance sector and/or in regulations may result in the potential for systemic risk due to either insurers taking on risks and product offerings that are missing from

[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.

[2] http://www.actuary.org/pdf/finreport/Academy_FIO_response_111219.pdf

insurance regulation oversight (as occurred with AIG) or due to a regulatory climate that allows for uneven or non-existent regulations for similar risk exposures (as occurred in the housing mortgage market), or allows for multiple jurisdictions to regulate only aspects of the enterprises with inadequate communication between regulatory authorities. The Task Force identified several potential drivers for increased systemic risk, such as:

  - Globalization of the insurance industry
  - Insurance companies that are affiliated with/owned by non-insurance financial services companies
  - Activities of non-insurance financial services groups in the assumption of insurance risk
  - Uneven existing regulations in an increasingly complex environment

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 basis for any additional prudential regulation related to systemically important financial institutions (SIFIs) with insurance affiliates needs to be an understanding of the specific underlying risks and business model, rather than based on a generic formula common to all companies across all segments of the financial services industry.

- The Task Force categorized potential regulatory gaps that should be addressed to more effectively minimize or manage systemic risk, such as Reliance Gaps and Regulatory Arbitrage:

  - Reliance Gaps, which are reliances by regulators 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 risks that are not regulated by functional insurance regulation. It also may arise where there is ineffective and inconsistent communication and regulation among functional regulators.

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 has done 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 products and structures.

* Another example of potential reliance gaps comes into play through regulatory arbitrage at the international level through foreign ownership or foreign reinsurance of US insurance companies and the extent to which there are regulatory differences between the US and foreign regulator.

Expanded oversight requires new tools, resources, and capabilities for regulators. Domestic and foreign regulators, as well as the NAIC and 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. Expertise within these regulatory functions is needed to effectively oversee, track, and remain proficient with the complexities of adaptive/evolving financial risk. These regulatory improvements would benefit from coordination at state, federal and international levels.

An effective and coordinated regulatory system will need to efficiently do the following:

- Implement a process to identify emerging risks and how they might be measured.
- 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.
- Coordinate monitoring of insurance companies who are members of systemically important financial groups.

The FIO, Financial Stability Oversight Council (FSOC), the Office of Financial Research (OFR), Functional State Regulators, NCOIL and the NAIC each have a critical role in developing and enabling the processes necessary to fully address emerging systemic risk. All those involved in the regulatory process must coordinate their oversight and regulation of the financial sector to accomplish the stated goals.

The American Academy of Actuaries Financial Regulatory Reform Task Force continues to work with all of these entities going forward to provide the actuarial expertise needed to execute these regulatory reform modernizations.

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).