



SOCIETY OF ACTUARIES

**ERM Symposium**  
**April 2009**

**RA4-Global Insurance Regulations, Risk  
Management and Credit Crisis Implications**

**Frank Sommerfeld**  
**Robert Klein**

**Moderator**  
**Michel Rochette**

	
<p style="text-align: center;"><i>Welcome!</i> <i>Bienvenue!</i> <i>Willkommen!</i></p> <div style="display: flex; justify-content: space-around; align-items: center;">      </div>	

<p style="text-align: center;">Session RA4 Title</p>	
<p style="text-align: center;">Global Insurance Regulations Risk Management &amp; Credit Crisis Implications</p> 	

## Presenters



- Robert Klein, PhD
- Michel Rochette, MBA, FSA
- Frank Sommerfeld, DAV

**Actuaries**  
Risk is Opportunity®



## Topics



- Comparison of North American and European insurance regulations
- Alignment of insurance regulations and risk management principles
- Review of recent regulatory themes and reports: potential implications on future regulations
- Questions

**Actuaries**  
Risk is Opportunity®



## Recent Regulatory Reports



- G30 Report – Volcker Report - on Financial Reform: A Framework for Financial Stability
  - 22 core and 18 specific recommendations.
  - Systemic important FIs: New concept!
  - Shadow banking system: Hedge funds & private pools of capital.
  - Money-market funds: “Breaking the Buck”.
  - Cooperation between national and international regulators: Banking and Insurance.
  - Risk Management: Implementation of previous recommendations.

**Actuaries**  
Risk is Opportunity®



## Recent Regulatory Reports



- Turner Review: A Regulatory Response to the Global Banking Crisis
  - Review of what went wrong: Markets can be irrational, securitization and financial instability, failure of market discipline, misplaced reliance on sophisticated maths, procyclicality, rating agencies, leverage
  - What to do globally: Systemic approach, fundamental changes to accounting, capital and liquidity, regulations of credit agencies
  - Changes to the FSA itself: More intrusive. Bye Bye to pure principles based but not necessarily a return to rules based either.

**Actuaries**  
Risk is Opportunity®



## Recent Regulatory Reports



- Geitner's Treasury Outline: Framework for Regulatory Reform

- Addressing systemic risk: Systematically important firms – SIF - overseen by a single regulator with higher standards on capital and risk management, legal form irrelevant but based on what companies do.
- SIF criteria: Interdependence with other FIs, size, leverage, short-term funding, importance as source of credit for consumers and businesses.
- Registration of all hedge fund advisors, oversight and disclosure of OTC derivatives, money market funds.
- Protecting consumers and investors.
- Eliminating gaps in the regulatory structure.
- Fostering international coordination.

**Actuaries**  
Risk to Opportunity®



## Recent Regulatory Reports



- GAO 09-216: A Framework for Crafting and Assessing Proposals to Modernize the Outdated US Financial Regulatory System: provides an overview of what went wrong and outlines principles for changes.
- US Treasury: Blueprint for a Modernized Regulatory System. Paulson Report.
- A Call to Action: 20 Principles for Rebuilding the Financial System by the WSJ Future of Finance Initiative.
- IAIS: Developing recommendations based on Financial Stability Forum - now Board - and G20 recommendations.
- Others: Basel Committee on enhancing the regulatory framework, De Larosière's report on EU financial regulation.

**Actuaries**  
Risk to Opportunity®



## Proposed Regulatory Themes



- Pro cyclical: Make the regulatory system countercyclical. Build reserves – dynamic provisioning - in good times for the bad times. The Squirrel Principle!
- Leverage: Increased capital requirements – quantity and quality - and additional regulatory leverage ratios.
- Governance and risk Management: ERM, compensation practices, enhanced emphasis on Pillar II and Pillar III of Solvency II and Basel II. Enhanced expectations by regulators.
- Liquidity: Both funding and market. More ALM!
- Enhanced scenarios: More than stress tests to assess resiliency of each institution and impact on reputation.
- Fair Value: Mark-to-Market vs historical accounting. Still up in the air! Some FASB interim measures.

**Actuaries**  
Risk is Opportunity®



## Proposed Regulatory Themes



- Functional regulatory approach overhaul: Regulation based on the underlying risks, not legal form, in order to reduce regulatory arbitrage. Federal Insurance Charter and regulation?
- Systemic regulator: Big brother to check the too-big-to-fail and too-interconnected-to-fail institution. FED or FDIC?
- Credit Rating Agencies Reform. May come under a new regulatory framework and modified pay structure. Self regulation at IOSCO's level didn't really work. A similar approach as to PCAOB?
- Credit Default Swap Market: Creation of clearinghouse and exchanges for vanilla CDS, enhanced capital requirements. Impose insurance model on the CDS market as in NY?
- Securitization: More transparency, have sponsors – Fls – keep skin in the game.

**Actuaries**  
Risk is Opportunity®



# Questions



- Thank You!
- Merci!
- Dankeschön!

**Actuaries**  
Risk is Opportunity®



# Insurance Regulation & Risk Management: A U.S. Perspective



ERM Symposium  
May 1, 2009  
Chicago, IL



Robert W. Klein  
Center for RMI Research  
Georgia State University  
E-Mail: [rwklein@gsu.edu](mailto:rwklein@gsu.edu)

## The Financial Crisis

- The current financial crisis has drawn considerable attention to the regulation of financial institutions & their RM practices.
- A discussion of revamping the structure for financial regulation was already underway when the crisis worsened.
- Recent developments will undoubtedly affect the reform process, priorities and outcomes.
- How they will be affected is less clear, but there are some indications.

## Systemic Risk

- Recent developments have demonstrated the significance of systemic risk and its cascading effects.
- There is need to have a good understanding of what “systemic risk” actually is, how it arises, what are its likely sources, and how it affects different kinds of firms.
- “Systemic risk is the risk of sudden collapse of an entire system or entire market and not to any one individual entity or component of that system. It can be defined as “financial system instability, potentially catastrophic, caused or exacerbated by idiosyncratic events or conditions in financial intermediaries”. It refers to the risks imposed by interlinkages and interdependencies in a system or market, where the failure of a single entity or cluster of entities can cause a cascading failure, which could potentially bankrupt or bring down the entire system or market.” (from Wikipedia)

## Systemic Risk & Insurance Companies

- Arguably, with a few exceptions, insurance companies are not likely to be a major source of systemic risk.
- Exceptions include AIG’s investment subsidiary and “mono-line” financial guaranty insurers.
- The nature of insurers’ products and investments do not typically pose systemic risk to the financial sector or the broader economy.
- However, insurers are on the receiving end of systemic risk and can (have) suffer(ed) significant asset losses due to systemic problems in the economy.

## **Implications for Regulation & ERM**

- Regulation is likely to focus on a handful of insurance firms & their holding companies that could pose or contribute to systemic risk in the economy.
- How regulation will be used to limit insurers' exposure to systemic risk is an important question without a clear answer.
- What is clear (to me) is that the current system of insurance regulation in the US is antiquated & ill-equipped to deal with systemic risk & other risks faced by insurers.
- ERM is being reassessed in light of current events but it plays no significant role in US regulation at present.

## **Insurance Regulation in the US**

- In the current system, primary regulatory authority is delegated to the states w/ limited federal intervention.
- It is a rules-based system that focuses primarily on insurers' compliance with an extensive set of regulations based on accounting valuations.
- In practice, little attention is truly paid to "RISK" from an economic/financial perspective.
- Risk-based capital standards & early warning systems employ static formulas & ratios.
- Current measures do not measure risk to macro events, industry-specific problems, catastrophes, etc.
- No significant weight is given to forward-looking, dynamic financial analysis or ERM practices.

## The Need for Reform

- US regulation needs to move to a principles-based approach with a greater emphasis on risk and ERM.
- Risk and capital adequacy should be assessed using some form of dynamic modeling, either company internal models (meeting certain standards) and/or a standard model.
- Existing regulations should be revisited given the framework for capital standards & risk assessment.
- Current regulations inadequate to deal with securitization.
- Regulators (and some companies) will need to gear up for a new system.

## Reform Checklist

- Capital Standards/Requirements
- Risk Management
- Financial Reporting/Accounting Rules
- Monitoring & Analysis Systems
- Stress Tests?
- Investments
- Reinsurance
- Intervention/Receiverships/Guaranty Associations
- Holding Company Supervision
- Rating Agencies
- Coordination with International Standards



## Prospects for Reform

- There is a heated debate about whether insurance regulation should be moved to the federal government (e.g., an Optional Federal Charter).
- Different reform scenarios are possible depending on whether federal regulation is established.
- The prospects for reform at the state level are uncertain; the NAIC is considering principles-based regulation but it is likely to move at a slow pace.
- The states are unlikely to embrace a major paradigm shift in the foreseeable future.
- State regulators are more likely to tinker with the current system as they have done in the past.

## Prospects for Federal Regulation

- Adoption of OFC or other federal system is unlikely in the near future but much more likely in the long term.
- Some form of systemic oversight may appear more quickly, but it is likely to be narrowly focused.
- Insurance will eventually be brought into the federal framework for regulating financial institutions and markets.
- It is reasonable to expect that federal regulators will attempt to integrate their regulation of insurance within the overall framework for financial regulation.
- This implies that the approach to the financial regulation of insurance companies could change significantly, but the details remain to be seen.
- Can banking “model” be applied to insurance?

## Implications for ERM

- Although state regulators currently pay little attention to ERM this could change.
- Federal regulators would be more likely to incorporate ERM more quickly in their regulatory framework.
- ERM is not a panacea; it is a process that warrants continuing reevaluation & improvement.
- Models can be seductive but they require proper use and interpretation.
- Attention to model assumptions & the limits to their scope is critical in the ERM process.

## Concluding Thoughts

- Systemic risk is important but it shouldn't eclipse attention to other risks that insurers face, e.g., pandemics, catastrophes, D&O claims, etc.
- What are the limits to risk management?
- Regulation will change but the process will be long and tortuous and it is difficult to predict exactly what will unfold and when.
- Insurers may have some understandable trepidation about significant changes to the current system.
- Insurers that can anticipate and prepare for regulatory changes will have an easier time.
- More insurers need to adopt and improve their ERM practices.