SOCIETY OF ACTUARIES

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Update on Regulatory Developments

By Francis de Regnaucourt

OVERVIEW

This is a quarterly update on developments at the National Association of Insurance Commissioners (NAIC), the International Association of Insurance Supervisors (IAIS), as well as other groups who may get involved in group supervision, with emphasis on those that may be important to members of the Financial Reporting Section.

As the Federal Reserve meets with the non-bank systemically important financial institutions (SIFIs) in the first half of 2014, many are wondering how it will approach this new creature—the insurance group (new to them, anyway). There is a lot to be learned by reading their report on evaluating bank holding companies (BHCs). The nature and duration of the risks are different, but the fundamental approach to capital adequacy should not differ much. Moreover, the Fed material is very clearly written—an enjoyable read for anyone interested in risk management.

On the NAIC side, the spring meeting of the Life Actuarial Task Force (LATF) showed continued progress on a large number of fronts, but nothing major coming to a conclusion. We report below on a few items that may be of interest to members.

Finally, on the international side, the only major event reported by the IAIS this quarter was that there would be workshops for volunteers for field testing of Global Capital Requirements in Basel, Orlando and Tokyo in March and April. Volunteers would be employees of companies that could be designated as internationally active insurance groups (IAIGs). We will continue to monitor developments.

THE FEDERAL RESERVE'S REGULATORY EXPECTATIONS

The term SIFI refers to financial institutions, other than BHCs, that will be regulated by the Fed going forward. At this stage, there are three SIFIs designated by the Financial Stability Oversight Council (FSOC): AIG, GE Capital and Prudential. MetLife, as of this writing, is still in Stage 3 review.

The FSOC was formed to identify and monitor risks to the U.S. financial system. It was formed to be the single source performing this function and fill in the gaps that existed when each of the eight bank regulators (OCC,[1] OTS,[2] the Fed, FDIC,[3] FHFA,[4] CFPB,[5] CFTC,[6] NCUA[7]) monitored risks separately. The FSOC is chaired by the Secretary of the Treasury; it has nine other voting members: representatives of the eight bank regulators, and a president-appointed insurance representative (currently Roy Woodall, a past insurance commissioner of Kentucky). There are also non-voting members (see Office of Financial Research below).

The Fed's first meetings with the SIFIs are scheduled to take place in the first half of 2014, and little is known

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currently about how they plan to approach regulation of non-banks. In August 2013, however, they published a report ("Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice") describing their expectations for internal planning at the large BHCs (referred to as CAP—capital adequacy process). The Fed's Capital Plan Rule requires all large BHCs to have a capital plan; Comprehensive Capital Analysis and Review (CCAR) is their supervisory program for assessing the plans against the seven CAP principles in the preamble to the Capital Plan Rule (see Table 1). If the CCAR reveals weaknesses in the capital plan, the Fed may disallow company capital actions such as dividend increases or share repurchases.

The report discusses each of those principles in greater depth, describing what the Fed expects from BHCs, what they have seen in practice, and what they consider leading practices and lagging practices. In their conclusion, they acknowledge that internal capital planning has evolved considerably since the financial crisis and the Capital Plan Rule, but list areas in which some BHCs continue to fall short of leading practices: "Overall, data limitations, unclear or unsubstantiated management assumptions, and poor documentation were the problems most prevalent across the BHCs." The label "lagging practice" is clearly defined as "unacceptable or in need of improvement."

Table 1. The Federal Reserve's Seven Principles of an Effective CAP[8]

1. Sound foundational risk management

   The BHC has a sound risk-measurement and risk-management infrastructure that supports the identification, measurement, assessment, and control of all material risks arising from its exposures and business activities.

2. Effective loss estimation methodologies

   The BHC has effective processes for translating risk measures into estimates of potential losses over a range of stressful scenarios and environments and for aggregating those estimated losses across the BHC.

3. Solid resource estimation methodologies

   The BHC has a clear definition of available capital resources and an effective process for estimating available capital resources (including any projected revenues) over the same range of stressful scenarios and environments used for estimating losses.

4. Sufficient capital adequacy impact assessment

   The BHC has processes for bringing together estimates of losses and capital resources to assess the combined impact on capital adequacy in relation to the BHC's stated goals for the level and composition of capital.

5. Comprehensive capital policy and capital planning

   The BHC has a comprehensive capital policy and robust capital planning practices for establishing capital goals, determining appropriate capital levels and composition of capital, making decisions about capital actions, and maintaining capital contingency plans.

6. Robust internal controls

   The BHC has robust internal controls governing capital adequacy process components, including policies and procedures; change control; model validation and independent review; comprehensive documentation; and review by internal audit.

7. Effective governance

   The BHC has effective board and senior management oversight of the CAP, including periodic review of the BHC's risk infrastructure and loss- and resource-estimation methodologies; evaluation of capital goals; assessment of the appropriateness of stressful scenarios considered; regular review of any limitations and uncertainties in all aspects of the CAP; and approval of capital decisions.

It is unlikely that the Fed will have exactly the same requirements of SIFIs as it does of large BHCs; the nature and duration of the risks are very different between the two. The statement "Importantly, the Fed has tailored expectations for BHCs of different sizes, scope of operations, activities, and systemic importance in various aspects of capital planning" shows their willingness to recognize the different nature of insurers. That said, the fundamental principles of capital planning are broad enough to be applicable to all financial institutions. In fact, the description of capital planning is very similar to those of Solvency II and the NAIC's Own Risk and Solvency Assessment (ORSA). The Fed's report is the best indication currently available on what regulation of SIFIs will look like.

On March 26, 2014, the Fed approved the capital plans of 25 BHCs based on their CCAR results as of Sept. 30, 2013. It did not, however, approve the planned capital actions (dividend increases or share buybacks) of five other BHCs. In one instance, the BHC's projected Tier 1 capital ratios fell below the 5 percent minimum in the "severely adverse" scenario—a deep recession with a rising unemployment rate, steep drop in housing prices and a nearly 50 percent decline in stock prices over nine quarters. In other instances of non-approval, the Fed cited "overall reliability of [the bank's] capital planning process." This is a clear example of the link between CCAR and regulatory actions.

Negative economic factors affect insurers as well as banks, but they do not translate into losses of capital as directly as for banks, especially those involved in direct lending. Our previous assertion—that it is premature to predict the effect of Fed regulation on insurers—stands.

SYSTEMIC RISK MONITORING AT THE OFFICE OF FINANCIAL RESEARCH (OFR)

During a webcast sponsored by the American Academy of Actuaries (AAA), Rebecca McCaughrin, associate director at the OFR, discussed the OFR's systemic risk monitoring framework. The OFR supports the FSOC by:

- Analyzing threats to financial stability: developing metrics and tools for monitoring and analyzing risks

> "Negative economic factors affect insurers as well as banks, but they do not translate into losses of capital as directly as for banks, …"

- Conducting research on financial stability: evaluating stress tests, proposing other potential stability-related assessments, reporting on market disruptions, and analyzing policy tools and responses
- Addressing gaps in financial data: promoting data integrity and accuracy for all users
- Promoting data standards: working with industry, regulatory, and others to establish global data standards, such as global legal entity identifiers (LEI).

The basic questions they are trying to answer are:

- Can the companies meet their basic financial tasks?
- Where are the risks accumulating?
- What regulatory policies should be established?

One of the OFR's successes so far is a set of unique identifiers (analogous to CUSIP) for counterparties, to help assess risk exposures and fill data gaps in securitizations, especially for counterparty risk.

With respect to insurers, McCaughrin mentioned two concerns:

- Asset and liability data is more time-lagged, and less granular, than what they see with banks, making early detection of risks more difficult.
- Microstructures (captives) and the lack of sufficient data to truly understand their associated risks.

OFR is currently developing a financial stability model—a heat map of the entire financial services system across five areas of risk: macroeconomic, market, credit, funding and liquidity, and contagion. Its purpose is to provide FSOC members with a global view of the severity of each of those areas and their components.

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The OFR is still in its early days, but any addition to data and research on financial systems risks is always welcome. We look forward to hearing more from them.

LATF MEETING AT THE NAIC SPRING MEETING, ORLANDO, FLA., MARCH 27-28, 2014

We report briefly here on new or substantial developments at this meeting. We hit only the highlights of the meeting; complete details are in the minutes produced by the NAIC and available on their website. In addition, there was forward progress on many ongoing projects, albeit without landmarks; we do not report on those.

NEW VALUATION MORTALITY TABLE

Mary Bahna-Nolan (AAA Life Experience Subcommittee) reported that they hoped to expose a proposed 2014 VBT mortality table by the end of April 2014, with a view toward a final report at the end of August. They are still working on the slope of the mortality curve at older ages. She also asked for guidance from LATF on the level of margins to be used in developing the corresponding valuation table.

VM-22 WORKING GROUP—KANSAS FIELD TESTS

Mark Birdsall (VM-22 Working Group) reported on the Kansas field tests. This group is distinct from the AAA's Annuity Reserving Working Group, but they work in parallel. They chose to try to advance the thinking on non-variable deferred annuity reserving, rather than just cutting and pasting from VM-20. Their focus is on floor reserves to be defined in VM-22.

Their focus is on listed benefits in the contract; guaranteed lifetime income benefit (GLIB) is the only one they are currently working on. They are developing a practical and auditable approximation of a stochastic process, as follows:

Floor reserve = maximum of (formula reserve, alpha, beta) where

- Alpha = Highest PV of benefits if listed benefits are paid for and eventually used
- Beta = Highest PV of benefits if listed benefits are discontinued at the valuation date

They are aiming for more sophisticated modeling of policyholder behavior (essentially the choice between annuitizing and deferring) to reflect the in-the-moneyness of the benefits, and made a few observations on GLIB utilization:

- Qualified contracts should have higher annuitization rates than non-qualified, given the minimum required distributions.
- Even a single-owner annuity may allow for joint-and-survivor annuitization options. On the valuation basis, they noted that joint options were richer than single-life ones (that is, higher PV of benefits), so utilization rates should reflect this, rather than assume that all options are actuarially equivalent.

SMALL COMPANY EXEMPTION FROM PBR

John Bruins from the American Council of Life Insurers (ACLI) presented more details on the small company exemption request, which had been introduced at the Fall 2013 Meeting. The current proposal would exempt companies provided they had (a) less than $300 million[9] of ordinary life premium (or are members of a

group that has less than $600 million), (b) risk-based capital (RBC) greater than 225 percent, and (c) no secondary guarantees, other than "non-material" (defined as nominal guarantees with limits on the length of the secondary guarantee, or the ratio of premium to net valuation premium).

As before, regulators voiced sympathy in principle for very small companies, but balked at the idea of exempting a company with nearly $300 million of ordinary premium. The proposals will be exposed for 45 days.

INDEX-LINKED VARIABLE ANNUITIES SUBGROUP

Blaine Shepherd (subgroup chairman) reported that this subgroup was formed as a result of regulatory concerns around new products named variable annuities, but where the policyholder values are based on indexes, not necessarily on specific separate account performance. Their questions are:

- Should reserves be calculated according to the Variable Annuity model regulation or the Modified Guaranteed Annuity model regulation? Or a hybrid of the two?
- How should minimum non-forfeiture values be calculated?
- Are these contracts covered under state guarantee funds?

The industry recommends the VA model, but several regulators expressed a feeling that changes may be needed for these products. The subgroup published a list of concerns in January, and asked interested parties to respond to that list. ■

ENDNOTES

[1] *Office of the Controller of the Currency.*
[2] *Office of Thrift Supervision.*
[3] *Federal Deposit Insurance Corporation.*
[4] *Federal Housing Finance Association.*
[5] *Consumer Financial Protection Bureau.*
[6] *Commodity Futures Trading Commission.*
[7] *National Credit Union Association.*
[8] *Source: "Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice," U.S. Federal Reserve, August 2013.*
[9] *Chosen to exempt about 10 percent of the industry by premium, per John Bruins (ACLI).*

analyst

specialist

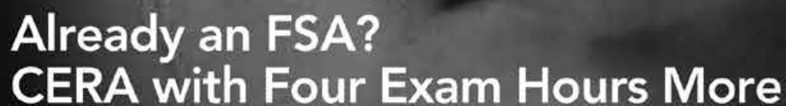
consultant

director

strategist

leader

executive



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