



SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

December 2013 – Issue 95

Systemically Important Financial Institutions (SIFI)— An Insurer’s Perspective

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The financial crisis of 2008 is still fresh in the minds of those who work within the financial services sector. Many believe this financial crisis was brought about by three interrelated causes: 1) the rapid growth and collapse of the U.S. housing market, 2) the pervasive decline of mortgage underwriting standards, and 3) widespread mismanagement of financial risks related to mortgages and derivatives. While U.S. banking organizations were in the forefront, non-bank financial companies (NBFCs) were also impacted by the financial crisis. NBFCs are financial institutions that provide banking services, but do not hold a banking license. These institutions may engage in lending, insurance, investment banking, asset management and other related activities. During the crisis, NBFCs were not subject to the prudential regulation and supervision applied to banks to monitor and address systemic risks.

Emerging from this financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or the Act). The Act created the Financial Stability Oversight Council (FSOC) to comprehensively monitor risks that affect the entire U.S. financial industry. The goals of Dodd-Frank are the following:

- To promote the stability of the U.S. economy by improving accountability and transparency in the financial system,
- To end “too big to fail,”
- To protect taxpayers by ending bailouts, and
- To protect consumers from abusive financial services practices.

The commonly held view is that the primary purpose of the Act is to manage systemic risk. Within this context, systemic risk is the potential for a sudden or unforeseen shock to cause considerable turmoil in financial markets. The ripple effects of such turmoil could spread into equity and bond markets and trickle down to affect household spending decisions.

SIFIs

Congress determined that any Bank Holding Company (BHC) with assets of \$50 billion would be a Systemically Important Financial Institution (SIFI). For NBFCs, the FSOC provided interpretative guidance (called the Rule) in April 2012 as to the criteria by which an NBFC would be considered systemically important to U.S. financial stability. The FSOC follows a three-stage process to identify NBFCs which might pose a systemic financial risk.

Stage 1:

NBFCs must have \$50 billion in total worldwide assets and meet at least one of the five thresholds shown in the table below.

Firms that do not meet the \$50 billion base or any of these thresholds are not necessarily exempt. The Rule indicates that the FSOC may further assess the systemic risks of certain firms that do not currently disclose sufficient information to make the necessary determination.

Criteria	Thresholds
Gross notional credit default swaps outstanding for which the firm is the reference liability	\$30 billion
Derivative liabilities	\$3.5 billion
Total debt outstanding	\$20 billion
Leverage ratio (total consolidated assets to total equity)	15:1
Short-term debt ratio (total outstanding debt with maturity less than 12 months to total consolidated assets)	10.0%

Stage 2:

Firms that meet the stated thresholds in Stage 1 automatically enter Stage 2. The FSOC will rely on public information and material available from the regulators to determine the firm's threat to financial stability. If there is insufficient information to make a determination, the firm will move to Stage 3. A large NBFC may not be moved to Stage 3 if the FSOC is satisfied that the firm does not currently pose a systemic risk. Presently, only firms moving to Stage 3 receive notification whereas the other non-notified firms remain in Stage 2.

Stage 3:

The FSOC will issue a Notice of Consideration to the NBFC, which will include a request for additional information. Once the FSOC has the appropriate information needed to make a designation, it will issue a Notice of Proposed Determination. If the FSOC determines that it will designate an NBFC as systemically important it will provide advance notice to the firm. If an NBFC has been deemed a SIFI, it has the right to bring action in U.S. federal court to rescind the determination.



THE IMPLICATIONS OF NBFC DESIGNATED AS SIFIs

In short, the NBFC and related subsidiaries will be subject to examination by the Federal Reserve Board (Fed), including enhanced regulatory reporting requirements to determine if the financial condition and its systems for risk monitoring can pose a threat to the financial stability of the United States. The burden will be greatest for the initial designees as the scope and clarity on the regulatory requirements are evolving. The enhanced standards for SIFIs include higher capital and liquidity requirements and additional oversight.

INSURERS AS NBFC SIFIs

Within Dodd-Frank, Title V establishes the Federal Insurance Office (FIO) within the Department of the Treasury and may signal that the federal government will play a larger regulatory role over insurance companies. The FIO has the authority to recommend that the FSOC designate an insurer and related subsidiaries as a potential risk to the financial system.

COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW

Both bank and non-bank SIFIs could be subject to additional oversight by the Fed including the Comprehensive Capital Analysis and Review (CCAR) involving stress testing. SIFIs could be required to pass the Fed stress tests in order to implement their capital plans. Currently, the CCAR requirements have a banking focus (bank-centric) rather than an insurance focus (insurance-centric) which can pose significant challenges when applied to insurance companies.

CONSIDERATIONS FOR INSURANCE COMPANIES

The banking industry is already accustomed to providing submissions to the Fed, but for insurers this is a major endeavor. Some insurers have begun preparations to assess their own readiness and to build out capabilities for the potential CCAR-like submissions. Insurers should include the following areas for consideration in their preparation for a CCAR submission:

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- **Timing**—Typically the Fed's economic guidance is provided to SIFIs in mid-November with the annual CCAR submissions due in early January of the following year. Insurers would be subject to a tight timeline from receipt of the Fed's guidance—generation and compilation of results, management and board review, and submission to the Fed.
- **Assumptions and Scenarios**—The insurers will face challenges in translating the Fed's economic guidance to company, business unit, and product specific assumptions. Typically, the Fed will provide guidance on the movement of economic indices for each scenario and the SIFI would translate these in a manner appropriate for their business. Generally three to five scenarios would be tested concurrently. Three scenarios will be derived from detailed guidance and assumptions published by the Fed (base, adverse and severely adverse), while additional scenarios would be company specific (base and stress).
- **Data**—The CCAR submission requires the insurer to complete the required schedules on an annual basis in addition to the capital plan. Also, there could be less intensive quarterly and monthly submissions. The typical insurer may not be able to readily access all the information necessary to populate these schedules. The key priorities to capture the data requirements are:
 1. Understanding the Fed data definitions relative to the insurer's data definitions,
 2. Identifying the availability of the data necessary to populate the CCAR schedules, and
 3. Determining a method to efficiently access the necessary data.
- **Models**—Insurers use complex actuarial and financial models to assess risks and develop projections of earnings and capital. A major challenge for insurers is to incorporate scenario stress testing capabilities under multiple reserving bases to meet the CCAR reporting timelines. For the more complex insurance products, stochastic models may be needed and add additional complexities.
- **Documentation**—The CCAR submission process requires extensive documentation and should include the following:
 1. Internal Stress Testing Methodologies—The submission should include documentation that describes methodologies and assumptions for performing stress testing of the insurer portfolios, the model development process, and derivation of outcomes and validations procedures.
 2. Assumptions—The insurer should provide support for insurer specific assumptions, including known weaknesses in the development of the assumptions; the use of management judgment should be supported and in line with scenario conditions.
 3. Scenario Assumptions—The insurer should include appropriate documentation of their approach related to the company baseline and stress scenarios.

For insurance companies designated as SIFIs, the undertaking to prepare for a CCAR submission is a major endeavor.

A LOOK FORWARD

The financial crisis set in motion Dodd Frank and a path toward designating SIFIs for both bank and NBFCs. At the time of this writing, Prudential,¹ AIG² and MetLife³ are at different stages of the SIFI designation. AIG and Prudential received the Notice of Proposed Determination. AIG selected not to appeal.



Prudential appealed, but the FSOC upheld its designation as a SIFI. Subsequently, Prudential announced they would not seek to rescind the designation and would focus on working with the FSOC to “develop regulatory standards that take into account the differences between insurance companies and banks.”⁴ MetLife has been moved to Stage 3. It is possible that other larger insurers will be designated in the future.

For insurance companies designated as SIFIs, the undertaking to prepare for a CCAR submission is a major endeavor. These designees could be subject to higher capital and liquidity requirements and additional oversight by the Fed. The requirements for the CCAR will likely evolve as the Fed adapts to the insurance framework; the possibility of changes in requirements is a source of uncertainty.

Currently the CCAR is perceived to have a bank-centric, rather than insurance-centric, focus. Insurance company risks derive from insurance product design, mortality/morbidity, accidents and natural disasters; these types of risks are not directly addressed in current CCAR stress tests. Most insurers may not currently be equipped to respond to the reporting timelines, data requirements, modeling needs, and documentation standards needed for submissions to the Fed. Insurance industry participants should look to educate the Fed on insurance related risks with the goal of helping to craft requirements with a more insurance-centric focus. This could help guide the Fed to develop CCAR submission requirements to yield a more relevant measure rather than a regulatory compliance exercise.

There is a view that the current regulatory capital framework should be used as a basis for assessing the insurance operations of a financial institution. One of the primary arguments is that the insurance industry has historically been successful in managing and containing insolvencies.

No matter what the final requirements are, this will likely be a game changer for companies designated as SIFIs. This could also have unintended consequences on insurance companies that are not likely to be designated. There might be an expectation that the CCAR scenario stress tests can be a valuable management tool for understanding the business’s risk exposure to extreme events and that the tests provide a comprehensive view of risk. Upgrading a company’s capabilities to handle the CCAR scenario stress tests would most likely lead to more reliable results, reporting efficiencies and better responsiveness of the management forecasting and reporting processes to current and future regulatory requirements. ■

ENDNOTES

¹ <http://www.investor.prudential.com/phoenix.zhtml?c=129695&p=irol-newsArticle&ID=1856493&highlight>

² <http://phx.corporate-ir.net/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1826573&highlight=>

³ <https://www.metlife.com/about/press-room/index.html?complID=104320>

⁴ http://news.prudential.com/article_display.cfm?article_id=6706