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Update on Regulatory Developments

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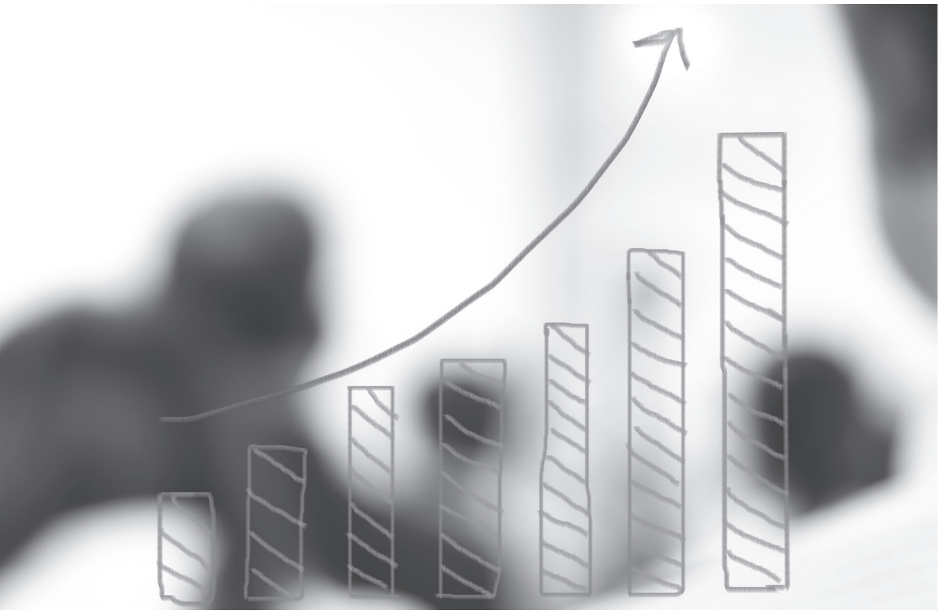
This is a quarterly update on developments at the National Association of Insurance Commissioners (NAIC), the International Association of Insurance Supervisors (IAIS), and other groups who may get involved in group supervision, with emphasis on those that may be important to members of the Financial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

The Life Actuarial Task Force (LATF) met at the NAIC Fall Meeting in November. I report below on a few items that may be of interest to members of this section.

In November, the Federal Reserve exposed a proposed order on standards to be applied to Systemically Important Financial Institutions (SIFI). The proposed order was limited to General Electric Capital Corporation (GECC), a non-insurer, so the standards for regulating insurers remain an open question. The Board reaffirmed its desire to tailor the standards for each SIFI on an individual basis.

In December, the U.S. Treasury's Financial Stability Oversight Council (FSOC) also issued a paper outlining the basis for its decision to designate MetLife, Inc. a SIFI. The paper gives more insight into FSOC's thinking on insurance risks, and would be excellent reading for anyone seeking to write an ORSA.



On the international side, the IAIS issued a 168-question Consultation Document on Insurance Capital Standards (ICS) for Internationally Active Insurance Groups (IAIG), with responses due in mid-February.

LATF MEETING AT THE NAIC FALL MEETING, WASHINGTON, D.C., NOV. 14 AND 15, 2014

I report here only the highlights of the meeting; complete details are in the minutes produced by the NAIC and available on their website. There was progress on many other ongoing projects, but no notable landmarks were reported.

New Valuation Mortality Table

John Bruins (ACLI) noted a few technical issues still to be resolved, and the Academy task force agreed that more work was needed on all but one of those issues. ACLI had questioned the use of different levels of mortality improvement by underwriting class. The task force defended the differences, stating they are justified by the results of the experience study.

There was discussion of the margin to be built into the CSO table (over the basic experience table). The current proposal is about 14 percent for nonsmokers and 18 percent for smokers, in order to cover about 80 percent of participating companies. The 2001 CSO, by contrast, had a margin of about 15 percent across the board.

The current plan is to have a table for adoption at LATF's 2015 summer Meeting.

Contingent Deferred Annuity (CDA) Subgroup

Tomasz Serbinowski (UT) reported little recent activity on the subgroup's three charges:

1. Evaluate whether AG 43 is appropriate for valuing CDA; recommend changes as appropriate.
2. Evaluate and recommend ways to exclude CDA from the nonforfeiture regulations.
3. Evaluate whether the current blank is appropriate for financial reporting of CDA; recommend changes as appropriate.

Regulation 695 (Synthetic Guaranteed Investment Contracts Model) Modernization

Dick Mattison (Transamerica) and Tina Kennedy (Pacific Mutual) presented a proposal to update the regulation. The need for modernization became clear in 2008 when Treasury rates hit an all-time low and credited spreads widened. Stable Value product results were hard hit, but not because of increases in expected claims. It was because the risk premium reduced the value of the assets considerably, but was not reflected in the liabilities. The resulting large fluctuations to surplus were not related to real business problems. Some states gave interim relief, but a more permanent solution is needed.

The proposal recommends that reserves be discounted at a 50-50 blend of Treasuries and a corporate bond index. The blend reflects the pass-through of spreads to the participating plans. Felix Schirrippa (NJ) expressed support for the proposal, and a desire to think more about how much RBC is appropriate for these products. Others expressed concerns that banks had exited these products because of low risk-adjusted margins. The proposal was exposed.

Stochastic Exclusion Test

John Bruins (ACLI) presented a proposal to eliminate stochastic analysis for blocks of business that are not very interest-rate sensitive. The proposal is to (a) calculate a GPV reserve (using existing Cash Flow Testing models, eliminating the need for a whole new model) on the base scenario and 15 prescribed alternative scenarios, and (b) determine the percentage over the base reserve for the highest of the alternative scenarios. If that percentage is less than 4.5 percent, stochastic calculations would not be required. The idea is that companies demonstrate low interest-sensitivity with a low percentage.

ACLI also asked for a change of percentage from 4.5 percent to 6 percent (he said 8% would actually be needed to avoid false negatives, per Towers Watson's 2012 paper), as well as more time for companies to implement PBR and see results. After some discussion, the proposal was exposed.

VM-22 Working Group—Kansas Field Tests

Mark Birdsall (VM-22 Working Group) made a few observations about the results of using the representative scenario technique in the field tests.

There are two companies in the field tests: Company A has moderate benefits, and company B has "Cadillac" benefits and higher charges. Under the representative scenario technique currently in use by the Working Group, Company A's results are at about 86 percent of CARVM, and less than the cash value floor. Company B, by contrast, is at about 110 percent of CARVM. He concluded that the representative scenario technique is doing a good job of reflecting the relative risks of product design, especially GLIB utilization and in-the-moneyness.

REGULATION OF SIFI—FEDERAL RESERVE AND FSOC ACTIONS

On Nov. 25, 2014, the Federal Reserve Board exposed a proposed order[1] for public comment on the capital standards for GECC, the only current nonbank SIFI that is not an insurance group. The proposed standards are substantially similar to those of similarly sized bank holding companies (BHC), based on the Fed's assessment that GECC's activities are substantially similar to those of large BHCs, and based on GECC's business models, capital structures, risk profiles, and systemic footprints. GECC will be required to meet substantially the same requirements (including stress testing) as a large BHC. The public comment period ends on Feb. 2, 2015.

Notable for insurance groups is that this order applies to GECC only and the Fed made clear its ability and intention "to tailor the enhanced prudential standards among companies on an individual basis, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors."

On Sept. 30, 2014, the Fed had initiated a quantitative impact study (QIS) to evaluate the potential effects

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of revised regulatory capital frameworks on firms substantially engaged in insurance. This may include savings and loan holding companies[2] as well as the other three nonbank SIFIs. The QIS is in response to the Collins Amendment, which requires that the risk-based capital and leverage requirements be at least as stringent as those applied to insured depository institutions. The Fed believes that bank-like capital standards are not appropriate for insurance companies, and the QIS is designed to be an information-gathering step in the process of developing capital standards that would be appropriate to insurers.

On Dec. 19, 2014, FSOC announced its decision to designate MetLife a SIFI. The decision was accompanied by a 30-page legal paper titled, "Basis for FSOC's Final Determination Regarding MetLife, Inc."[3] While the paper is couched in terms of legal support for the determination, it offers discussion and insight into FSOC's thinking on many of the top risk issues for insurers, not just MetLife:

- Funding agreements, GICs, and synthetic GICs;
- Securities lending;
- Captive reinsurers; and
- Variable annuities.

The paper also discusses issues specific to the size and risk footprint of SIFIs, and how disruption at a SIFI can spread to threaten U.S. financial stability:

- Risk transmission: spread of financial losses;
- Critical function and service issues; service disruptions to significant clients; and
- Resolvability: how the sheer size and complexity of a SIFI could hinder or help the ability to resolve its estate.

MetLife still has many legal options, so this paper is unlikely to be the last word on the matter. It does, however, provide a thoughtful and thorough analysis of the thorniest risk issues in the industry. As risk managers prepare for ORSA requirements, this paper is highly recommended reading for its thorough discussion of the most material risk issues.

IAIS CONSULTATION DOCUMENT ON ICS

On Nov. 6, 2014, the Financial Stability Board (FSB) of the G-20 announced that the ICS would replace the Basic Capital Requirements, the previous measure of required capital adequacy. On Dec. 17, 2014, IAIS issued a consultation document as the first step in establishing the ICS; responses are due in mid-February. The second step is field testing, which is expected to happen during 2015. The goal is to finalize the ICS by the end of 2016, with a view to adopting them as part of ComFrame, by the end of 2018.

The consultation document poses 168 questions to respondents along the following broad lines:

1. Fundamental issues of ICS appropriateness, comparability, and integration of risks across sectors.
2. Margins over Current Estimate (MOCE) requirements.
3. Market-adjusted valuation approach, especially for long-term business.
4. Yield curve for discounting insurance liabilities.
5. GAAP with adjustments valuation approach.
6. Definition and classification of qualifying capital resources.
7. Tier 1 capital resources.
8. Tier 1 instruments.
9. Tier 2 capital resources.
10. Non-controlling interests and deductions form tier 1 resources.
11. Capital composition limits.
12. Should capital be prescribed? Should there be a backstop?
13. Risks not included or not quantified.
14. Choice of risk measure and practical solutions for tails.

15. Appropriateness of a one-year risk time horizon.
16. Field testing.
17. Recognition of risk mitigation.
18. Participating policies and profit sharing.
19. Dependencies of risks, relationships, diversification.
20. Look-through approach options.
21. Grouping of risks.
22. Stress vs. factors approaches for risk measurement.
23. Sub-risks for mortality and longevity.
24. Segmentation and granularity for each of the risk categories.
25. Morbidity and disability risks.
26. Lapse and mass lapse.
27. Expense risk.
28. Premium risk.
29. Claims reserves risk.
30. Catastrophe risk.
31. Stress scenario definition.
32. Market risk.
33. Interest rate risk.
34. Equity risk, including volatility risk.
35. Equity type bucketing issues.
36. Specific examples of equity bucketing.
37. Real estate risk.
38. Currency/FX risk.
39. Asset concentration risk.
40. Credit risk.
41. Operational risk.
42. Use of variance/covariance matrix.
43. Use of variations in method.
44. Internal models.

The document also has five appendices (the first three are on 2014 field testing):

1. Market valuation approaches for field testing.
2. Rationale for the approaches.
3. Field testing results.
4. Other considerations for selecting methodology—auditability, cost, etc.
5. Definition of insurance line of business segments.

This very high level summary does little justice to the entire paper, which can be downloaded as a PDF from http://www.iaisweb.org/News/Consultations/Risk-based-Global-Insurance-Capital-Standard-1220. One has to be (a) impressed by the IAIS's thoroughness in setting out these questions, and (b) somewhat awed by the amount of work it will take to reach consensus on a set of ICS that can apply worldwide. ■

ENDNOTES

[1] The full text of the Fed's press release and proposed order can be found at: *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141125b1.pdf.*

[2] The list of savings and loan holding companies supervised by the Fed as of June 30, 2014 included several large insurers, including: State Farm, TIAA-CREF, Modern Woodmen of America, and New Jersey Manufacturers. The full list can be found at: *http://www.newyorkfed.org/aboutthefed/SLHCList.pdf.*

[3] Available at: *http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf.*