Article from

The Financial Reporter

September 2015
Issue 102

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), the Federal Reserve and affiliated entities, as well as other groups who may get involved in insurance supervision, with emphasis on those that may be important to members of the Financial Reporting Section. In general, this update does not report on principle-based reserves, as they are usually covered elsewhere.

The NAIC does not have an in-person meeting during the second quarter, but the Life Actuarial Task Force (LATF) and its working groups continue to push many initiatives forward. At this writing, there are no new finished items, but recent initiatives include:

- Review of AG 43 to make it applicable to Contingent Deferred Annuities (CDA);
- Exempting CDA from nonforfeiture (this charge is being hotly disputed by the Center for Economic Justice (CEJ)); and
- Drafting a new Indexed Universal Life (IUL) Life Illustration Actuarial Guideline (currently exposed).

The NAIC held its International Forum in May, and the issue of International Capital Standards (ICS) was at the forefront of many discussions. The deadline for ICS has been postponed indefinitely, partly because there is such a strong division of views on how they should be developed.

Similarly, the NAIC's ComFrame Development and Analysis Working Group held discussions on ICS at its March 2015 meeting. Even within the U.S., members showed a strong divergence of opinions.

At the same meeting, ex-Commissioner Hamm (ND), the NAIC (non-voting) representative to the U.S. Treasury's Financial Stability Oversight Council (FSOC), criticized FSOC's approach to insurance companies.

The Office of Financial Research (OFR), the research arm of the FSOC, issued its annual report at the end of 2014. Several issues in this report are directly relevant to insurance companies.

NAIC INTERNATIONAL FORUM, WASHINGTON, D.C., MAY 21 AND 22, 2015

Commissioner Lindeen (MT) opened the forum with a new definition of two time eras: BC (before the crisis) and AD (after Dodd-Frank).

Cybersecurity: In April, the NAIC adopted a set of 12 guiding principles[1] for state insurance regulators on the protection of the insurance sector's data security and infrastructure.

A few interesting observations were made:

- The Federal Trade Commission singled out identity theft as the single biggest source of complaints they receive.
- The insurance industry is targeted by hackers because it is a larger user of personal information, both financial and personal (e.g., health) than virtually all others ("Why rob a 7-Eleven when you can rob a bank?").
- Customer data is a valuable commodity and should be accounted for, just like policyholder funds, according to the CEJ.
- Two areas of "low hanging fruit" for policyholder data security are data encryption and eliminating non-essential data.
- The cybersecurity industry is still not mature. Problems include: shortage of experts, the need for more cooperation, and proliferation of different sets of rules.

Group Supervision: The panel agreed that group supervision is a useful tool, but is not a substitute for entity supervision. The group view can obscure things like double leverage and specific risks at unregulated entities within the group.

One speaker from the Fed said that shadow insurance keeps him up at night. He was referring to reinsurance transactions within a group that move risks from one part of the group to another where regulation is less stringent, or disclosure requirements less transparent.

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The views—from panelists and audience members—broke down into two groups with very different positions on capital standards, summarized as follows:

- The NAIC is continually improving regulation and will continue to do so. It is better to continue the gradual change process than to make a sweeping change, which takes a long time and creates dislocation. The current tools, including ORSA, are sufficient to assess capital adequacy, and will continue to evolve as new situations develop.
- Adoption of a single set of ICS is necessary to avoid jurisdiction-shopping. The change in global markets, especially the growth in Asia and developing markets, requires standards that are truly international. Supervisory colleges need a common standard, even if it is developed and implemented gradually.

Two interesting questions came from the audience; there was no time for answers, though:

- Do the costs of meeting all these standards, which are rising quickly, justify the benefits?
- What authority do the supervisory colleges really have, and what authority do they really need?

Centralized vs De-centralized Corporate Governance: A panel of four speakers from the Dubai Financial Authority, a large U.S. P&C insurer, a U.S.-based insurer SIFI, and the Dutch Central Bank discussed these two approaches to corporate governance. Salient observations:

- Recognition of local culture, while still meeting group-wide standards, is crucial. Regulatory colleges, by the same token, can best understand local culture by relying on local regulators.
- Governance is only as good as the behaviors of the people and the "tone at the top." Better to evaluate outcomes than rely on prescriptive rules.
- Insurer representatives said that there was good cooperation between regulators and management, but politely expressed some frustration with the cost of complying, and with regulators' perceived risk-avoidance bias in an industry that earns its profits by taking risks.

Global Insurance Capital Standards: The division of opinions was very similar to the NAIC session on Group Supervision, with a similar division of opinions. Panelists were: a New York State Senator who is president of the National Conference of Insurance Legislators (NCOIL), the CEO of the NAIC (a retired U.S. Senator), the secretary general of the IAIS, a law school professor, and a senior Insurance and Pensions expert at the European Union (EU). A few key observations:

- Solvency II got buy-in because the cost of having 28 different regulatory standards made the cost of cross-border business prohibitive within Europe. Maximum harmonization (with few options by country) was chosen over a broad-brush approach.
- The huge growth in Asian insurance markets highlights the need for a truly global regulation tool beyond Europe and North America.
- Six U.S. states, if they were independent countries, would rank in the largest 20 countries in the world (this argument given in support of keeping state regulation in the U.S.)

NAIC COMFRAME DEVELOPMENT AND ANALYSIS WORKING GROUP

This working group is charged with developing national capital standards and representing the U.S. in the development of ICS. With respect to national standards, there were essentially two views among U.S. NAIC members:

- One group contends that the U.S. need not follow Europe or the IAIS standards for Globally Systemically Important Insurers (G-SII), pointing out that there are different issues and different business models at play. Support for this view is based on the demonstrated, long-term strength of the U.S. regulatory system and the possible unintended consequences of a global group capital standard.
- The other group argues that if U.S. insurers want to retain any relevance internationally going forward, they need to comply with international standards. Supporters of this view point out that insurance customers are becoming more global and insurers are operating more globally, creating a need for a consistent global capital standard.

NAIC FINANCIAL STABILITY (EX) TASK FORCE

Adam Hamm, a former NAIC president, appeared before the Task Force, accusing the FSOC of regulatory malpractice. Hamm, who serves in a non-voting advisory capacity to the Council, voiced concern over the FSOC's decision to designate MetLife as a SIFI and the overall FSOC process. At this writing, MetLife is contesting its designation as a SIFI.

Hamm indicated that FSOC members:

- Do not understand the NAIC's requirements;
- Make decisions based primarily on the size of the company, ignoring other factors;
- Impose a virtually impossible burden of proof on insurers to dispute a SIFI designation;
- Presume implausible outcomes relating to the liquidation of assets in policyholder surrender scenarios;
- Do not recognize the positive impact of regulatory intervention by the states; and
- Fail to provide guidance to insurers about what the risks

are and how they can be mitigated.

OFR ANNUAL REPORT

In late 2014, the OFR issued its 2014 Annual Report to Congress.[2] The OFR was established by the Dodd-Frank Act to support the FSOC with research and analysis of the financial system, including insurance. The report has three main sections:

- Analysis of threats to the financial stability of the United States,
- Status of OFR efforts in meeting its mission, and
- Key findings from OFR's research and analysis.

The report is excellent reading for anyone interested in the Financial Services industry, but we limit our coverage to two areas directly relevant to life insurers, even those that are not Fed-regulated. In his cover letter, the director of the OFR summarizes financial stability risks as follows:

"The three most important [risks] are excessive risk-taking in some markets, vulnerabilities associated with declining market liquidity, and the migration of financial activities toward opaque and less resilient corners of the financial system."

CAPTIVE REINSURERS

The report's analysis of threats to financial stability has three themes:

- excessive risk-taking during an extended period of low interest rates and low volatility;
- an increase in market fragility resulting in declining market liquidity and persistent risks of asset fire sales and runs; and
- migration of financial activity away from banks toward less regulated parts of the financial system.

The third theme (migration) has particular relevance to life insurers, especially those with captive reinsurers. The OFR lists the dramatic growth in captive reinsurers as one of its top concerns with life insurers. A paper entitled "Shadow Insurance,"[3] by Koijen (London Business School, Centre for Economic Policy Research) and Yogo (Federal Reserve Bank of Minneapolis) is summarized in the abstract below:

"Liabilities ceded by life insurers to shadow reinsurers (i.e., less regulated and unrated off-balance-sheet entities) grew from $11 billion in 2002 to $364 billion in 2012. Life insurers using shadow insurance,[3] which capture half of the market share, ceded 25 cents of every dollar insured to shadow reinsurers in 2012, up from 2 cents in 2002. Our adjustment for shadow insurance reduces risk-based capital by 53 percentage points (or 3 rating notches) and increases default probabilities by a factor of 3.5. We develop a structural model of the life insurance industry and estimate the impact of current policy proposals to limit or eliminate shadow insurance. In the counterfactual without shadow insurance, the average company using shadow insurance would raise prices by 10 to 21 percent, and annual life insurance underwritten would fall by 7 to 16 percent for the industry."

Later in the report, ("Addressing Data Gaps"), the OFR lists three data concerns with captives:

- Statutory statements are publicly available for life insurers, but not for captive reinsurers;
- Incomplete disclosure of captives in SEC filings, especially on the use of parental guarantees to secure reserve collateral; and
- Offshore captives may have even less by way of substantive or disclosure requirements.

SECURITIES LENDING AND REVERSE REPURCHASE AGREEMENTS

Securities lending and reverse repurchase agreements are not particular to life insurers, but many insurers participate to significant degrees. The FSOC considers securities lending and reverse repos a factor in determining the degree to which an institution is systemically important; it is mentioned specifically in the Basis for Determination of all three insurer SIFIs.

The primary concerns about securities lending and reverse repos are:

- Data gaps, especially in the bilateral repos markets (where transactions are settled directly between the parties, without a third party settlement bank);
- Dependence on short-term funding (which can dry up quickly in times of stress);
- Counterparty exposure; and
- Interconnections between participants.

"The repo market is … susceptible to fire sales and runs when a borrower cannot roll over or renew short-term funding backed by collateral."

Not everyone agrees with these assessments, but the OFR's contribution to the debate over regulation of insurers in the U.S. appears thoughtful and articulate. ■

ENDNOTES

1. The guiding principles can be found at: *www.naic.org/documents/committees_ex_cybersecurity_tf_final_principles_for_cybersecurity_guidance.pdf*
2. The full report can be found at: *http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf*
3. Swiss Finance Institute Research Paper No. 14-64. Available at SSRN: *http://ssrn.com/abstract=2320921*

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