Regulatory Risk and North American Insurance Organizations

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SECTION 1. INTRODUCTION

1.1 Background and Purpose

This research report on regulatory risk in the North American insurance company environment was first contemplated through a discussion among members of the North American Actuarial Council's (NAAC) Collaborative Research Group. NAAC is a voluntary group of actuarial organizations located in the U.S., Canada, and Mexico. NAAC established a Collaborative Research Group, in part, to brainstorm on possible areas for partnered research on certain topics of interest to participating organizations. NAAC itself does not endorse findings from such research efforts. The subsequent funding and oversight for this particular effort were provided by the Casualty Actuarial Society, Canadian Institute of Actuaries, and Society of Actuaries.

The authors, Tom Herget and Dave Sandberg, are experienced practitioners and address regulatory issues on a daily basis.

The results of this research project are based on a compilation of interviews with regulators and industry leaders, discussions with industry government relations personnel, views of others found in presentations and reports, and personal experience of the authors.

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The purpose of this research is to a) identify regulatory structures and influences in North America, b) provide examples that illustrate regulatory risk, and c) suggest mitigation ideas for both insurers and their regulators. The audiences for this paper are a) actuaries who must price policies, value policies, or manage capital, b) other insurance professionals who deal with operational risk, strategic risk, and capital planning, and c) regulators who protect the interests of policyholders and address the solvency of insurers.

1.2 Contents

1.3 Regulatory Risk Definition

The authors searched textbooks, websites, PowerPoints and hallways for a definition of "regulatory risk". Several practitioners offered their viewpoints:

- Regulatory risk arises from rule-making or rule implementation which reduces an insurer's willingness to take risks in a prudent fashion on a cost-effective basis.
- Regulatory risk is the inability to predict a regulatory outcome.

- Regulatory risk occurs when the cost of the solution exceeds the benefits to the policyholders.

The authors felt the following best expressed the concept of regulatory risk addressed in this paper:

Regulatory risk embodies:

- *The potential and actual challenges faced by insurers and regulators under a supervisory regime arising from changes to products and/or regulations; and*
- *The intended and unintended results of regulations that put at risk the ability of policyholders, shareholders, or regulators to achieve their legal or fiduciary objectives.*

1.4 High-Level Summary

This paper initially presents the regulatory structures in the U.S., Mexico, and Canada. The paper then identifies the multitude of bodies that influence insurer regulation. The authors then present over thirty examples of regulatory risk in order to introduce the reader to the many ways in which regulatory risk surfaces. Finally, the authors present strategies that both the insurer and the regulator can employ to minimize regulatory risk.

1.5 Disclaimer

It should be noted that the opinions expressed and conclusions reached by the authors in this report are their own and do not represent any official position or opinion of the NAAC organizations or their members.

SECTION 2. INSURANCE REGULATION IN THE UNITED STATES

In 1945, Congress adopted the McCarran-Ferguson Act, which declared that states should regulate the business of insurance. The regulation of insurance stayed in the states' hands until some powers were transferred to the federal government with the passage of the Dodd-Frank bill in 2010.

2.1 States

State legislatures set policy for the regulation of insurance. The legislatures establish and oversee the state insurance departments, review and revise laws, and approve department budgets. The fifty states, one district, and five populated territories employ about 12,000 personnel.

2.1.1 Key Functions

The fundamental rationale for insurance regulation is to protect consumers. The supervision is structured around five key functions: company licensing, producer licensing, product regulation, market conduct, and financial regulation.

2.1.1.1 Company Licensing

Each insurer, of which there are about 7,000 in the U.S., must be licensed in any state in which it sells products or services. The insurers are subject to not only regulation in their state of domicile but in the other states in which they write business. Insurers who fail to comply with regulatory requirements are subject to fines, suspensions, or revocations.

2.1.1.2 Producer Licensing

Each state licenses agents and brokers to sell insurance. The 3 million-plus producers in the U.S. must comply with state laws and regulations. In addition to initial examination, states administer continuing education programs. Failure to comply can mean suspension or revocation of the license.

2.1.1.3 Product Regulation

The states ensure that insurance policy provisions adhere to state law, are reasonable and fair, and do not contain major gaps in coverage that might be misunderstood. The nature of policy form filing and approval varies somewhat from state to state.

Life insurance and annuity product premium rates are generally not subject to regulatory approval. Many states subject health insurance rates to prior approval for both initial and subsequent premium rates. For personal lines property and casualty (P&C) rates, about half the states require prior approval before they go into effect.

2.1.1.4 Market Regulation

Market regulation attempts to ensure fair and reasonable insurance prices, products, and practices. Market conduct examinations occur on a routine basis but can also be triggered by complaints against an insurer. These examinations review agent licensing, complaints, sales practices, rating, claims handling, and other market-related aspects. States have established toll-free hotlines, internet websites, and special consumer services units to receive and process complaints against insurers and their agents.

2.1.1.5 Financial Regulation

States enact laws and insurance departments establish regulations to create rules for reporting of assets, liabilities, and resulting surplus. The states also specify the rules for calculating risk-based capital, the mechanism for detecting weakly-capitalized companies.

Statutory accounting principles (SAP) have been codified. While states have attempted to uniformly introduce SAPs, there remain variations in content and effective dates between states.

Financial statements must be filed quarterly. Annually, the appointed actuary opines on the reasonableness of the reserves and their compliance with state-of-filing laws, regulations, and guidelines. Actuarial guidelines are developed nationally but may be accepted, modified, or rejected by insurance departments.

States examine their domiciled insurers periodically, usually once every three or five years. Should surveillance indicate pending or current impairment, the state's insurance department may take control of the company. In the event the company becomes insolvent or must be liquidated, the state maintains a guaranty fund that can cover policyholders' losses.

For an in-depth understanding of all aspects of state-based regulation, please see *The U.S. National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative* report on the NAIC's website.

2.1.2 Insurance Department Organization in Sample Jurisdictions

This section describes how insurance departments are organized in selected states.

2.1.2.1 California

The mission of the California Department of Insurance (CDI) is to act to ensure vibrant markets where a) insurers keep their promises, and b) the health and economic security of individuals, families, and businesses are protected. The CDI ensures that a) consumers are protected, b) the insurance marketplace is fostered to be vibrant and stable, c) the regulatory process is maintained as open and equitable, and d) the law is enforced fairly and impartially. There are 38 million California residents.

The CDI requires that P&C rates be pre-approved before going into effect. The CDI has sworn peace officers to investigate and arrest those who commit fraud.

The CDI currently licenses over 1,800 insurers, of whom about 235 are domiciled in California. More than 335,000 individuals and entities are licensed as agents, brokers, and adjusters. There are about 1,300 employees in the CID, of whom about twenty-five are actuaries.

The CDI's Insurance Commissioner is an elected position. The Commissioner appoints the Chief Deputy Commissioner, who presides over the seventeen branches' Deputy Commissioners. These Deputy Commissioners also serve at the will of the Commissioner.

The seventeen branches (with employee counts for the largest) are: civil rights, conservation and liquidation, administration, and licensing (275); rate regulation (90); consumer services and market conduct (160); financial surveillance (175); enforcement (375); legal, working groups, accountability, corporate affairs (150); policy and planning, community, legislative, communications, health policy, and special counsel.

Its website is www.insurance.ca.gov.

2.1.2.2 Florida

The mission of Florida's Office of Insurance Regulation (OIR) is to ensure that insurance companies licensed to do business in Florida are financially viable, operate within the laws and regulations governing the insurance industry, and offer insurance products at fair and adequate rates which do not unfairly discriminate against the buying public. Florida has 19 million residents. The OIR is part of the Department of Financial Services.

The OIR oversees 180 domiciled companies and plus another 1,500 insurers licensed to do business there. The department has 280 employees, of which twelve are actuarial. Its website is www.floir.com.

2.1.2.3 Illinois

The mission of the Illinois Department of Insurance (IDI) is "to protect consumers by providing assistance and information, by efficiently regulating the insurance industry's market behavior and financial solvency, and by fostering a competitive insurance marketplace." The IDI is one of 88 state agencies.

The Director of Insurance has a Chief Deputy Director who oversees three divisions: consumer-market, financial-corporate regulatory, and legal. Consumer-market has six sections: consumer services, cost containment, compliance (life and health), market conduct, producer, and compliance (P&C). Financial-corporate regulatory division has six sections: casualty actuarial, corporate regulation, financial regulation, financial examination, life actuarial and public pension.

The state of Illinois has 13 million residents. There are over 2,000 insurers licensed in the state; the IDI oversees 314 domiciled insurers. It has 260 employees and an annual budget of $45 million. The department employs about twelve actuarial professionals. The Director of Insurance is appointed by the Governor. The Chief Deputy Director is appointed by either the Director or the Governor. Assistant Deputy Directors and below are protected by the personnel code.

The website is http://insurance.illinois.gov.

2.1.2.4 Minnesota

The Minnesota insurance department is a division housed within the state's Department of Commerce. The Department of Commerce divisions are: consumer protection and education, energy, enforcement, banking and financial services, insurance, insurance fraud investigations, licensing, petrofund, securities, telecommunications, unclaimed property, and weights and measures. Its mission (in draft form at the time of this paper) is to: protect the public interest; advocate for Minnesota's consumers; ensure a strong, competitive, and fair marketplace; strengthen Minnesota's economic future; and serve as a trusted public resource for consumers and businesses.

Each division is overseen by an Assistant Commissioner. The insurance division's units are a) insurance product filing, b) workers' compensation self-insurance, and c) financial regulation. The insurance division houses ninety employees, of which less than five are actuarial professionals.

The Commissioner serves at the pleasure of the Governor, as do the Deputy and Assistant Commissioners.

The department oversees 160 domiciled insurers and another 1,170 licensed in the state. There are 5 million residents in Minnesota.

The budget for the department of insurance is $15 million. Its website is www.insurance.mn.gov.

2.1.2.5 Nebraska

The mission of the Nebraska Department of Insurance is "to safeguard those affected by the business of insurance through the fulfillment of our statutory obligations and by promoting the fair and just treatment of all parties to insurance transactions." In addition to the department's commitment to protecting the public interest, it also has an obligation to assist the insurance industry by providing consistent, unbiased, and equitable regulation.

The department's divisions are administration, administrative services, consumer affairs, financial regulation, fraud prevention, human resources, legal, life and health (policy forms), market conduct, producer licensing, and P&C (rates and forms).

Nebraska has four million residents. There are 100 employees in the NDI, of whom four are actuarial professionals. This state has 1,400 insurers licensed to do business, of which about sixty-five are domiciled here. The department is run on a budget of $15 million.

The Director of Insurance is appointed by the Governor. The eleven division heads generally have their positions protected, but they do serve at the pleasure of the Commissioner.

The department's website is www.doi.nebraska.gov.

2.1.2.6 New York

The state of New York has 19 million residents. The mission of its Department of Financial Services (DFS) is "to reform the regulation of financial services in New York to keep pace with the rapid and dynamic evolution of these industries, to guard against financial crises and to protect consumers and markets from fraud."

Its Superintendent, in order to better supervise financial products and services, including those subject to the provisions of the Insurance Law and the Banking Law, may take any actions necessary to "foster the growth of the financial industry and to spur state economic development through judicious regulation and vigilant supervision; ensure the continued solvency, safety, soundness and prudent conduct of the providers of financial products and services; ensure fair, timely and equitable fulfillment of the financial obligations of such providers; protect users of financial products and services from financially impaired or insolvent providers of such services; encourage high standards of honesty, transparency, fair business practices and public responsibility; eliminate financial fraud, other criminal abuses and unethical conduct in the industry; and educate and protect users of financial products and services and ensure that users are provided with timely and understandable information to make responsible decisions about financial products and services."

New York's DFS comprises two major divisions (insurance and banking) and several smaller ones (markets, real estate, general counsel, financial fraud, and consumer protection), which primarily support the two major divisions.

The insurance division has three bureaus: health, life, and P&C. The division is managed by an Executive Deputy Superintendent, who has several Deputy Superintendents. The three bureaus are run by Bureau Chiefs.

There are about 800 employees in the insurance bureau. Bureau Chiefs and all their employees have some job protection through either the civil service act or membership in a labor union. About sixty-five have actuarial backgrounds.

There are about 400 insurers domiciled in New York; about 1,400 entities write business in the state. The annual insurance division budget is about $145 million. Its website is www.dfs.ny.gov.

2.1.2.7 Forms of Organization in Select Other Countries

During the course of this research, the authors were in proximity to regulators from several countries outside of North America. Following are organizational structure descriptions for three of these jurisdictions.

2.1.2.7.1 Republic of South Africa

South Africa's insurance regulation is included in its total financial services regulatory agency. This agency is split into two components. One is for financial regulation of institutions; the other is for market conduct.

2.1.2.7.2 Taiwan

In Taiwan, a land of 23 million people, the Insurance Bureau (IB) regulates fifty insurers with a staff of 100. The IB is one of four agencies (the other three are banks, securities, and examinations). These comprise the Financial Services Commission, which is overseen by nine commissioners. Each commissioner is nominated by the Prime Minister and selected by the President. Once the commissioner's term is completed, he or she may not join (as employee, consultant, or director) any industry he or she was regulating.

The IB is supplemented by an equally-sized research institute, the Taiwan Institute for Insurance (TII). The TII is 100 percent funded by industry donations and performs work both for and independent of the IB. The IB and TII generally regulate insurance from the entity's perspective. An ombudsman agency, completely independent of the FSC, covers all consumer issues.

2.1.2.7.3 United Kingdom

In the UK, regulation and supervision is split between two agencies. Insurer prudential supervision is performed by the Prudential Regulation Authority, part of the Bank of England. The Financial Conduct Authority is an autonomous body, not part of the Bank, operating under powers granted by ministers and Parliament. It oversees the relationship between financial sector entities and their customers, both retail and wholesale. This includes insurers, financial advisors, and the financial markets and exchanges.

2.2 National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting development and regulatory support organization created and governed by the chief insurance regulators from the fifty states, the District of Columbia, and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review and coordinate their regulatory oversight. NAIC staff supports these efforts and attempt to represent the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

NAIC members are the elected or appointed state government officials who along with their departments and staff regulate the conduct of insurance companies and agents in their respective state or territory.

The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest and achieving fundamental insurance regulatory goals of protecting the public interest, promoting competitive markets, facilitating fair and equitable treatment of insurance consumers, promoting the reliability, solvency, and financial solidity of insurance institutions, and supporting and improving state regulation of insurance.

The NAIC employs about 425 people. Its major office is in Kansas City with other offices in New York City and Washington DC. Kansas City is the central office and comprises divisions for: communications, the executive, human resources, information systems, insurance products and services, legal services, member services, regulatory services, and technical services. The New York office is for capital markets and investment analysis; the Washington office is for government relations.

The NAIC operates on a budget of about $75 million. Its sources of income are primarily from the industry: 34 percent from database fees, 26 percent from services (SERFF, SBS, SVO, and IID), 24 percent from publications, 9 percent from licensing and administrative fees, 3 percent state assessments, 2 percent from education and training, and 2 percent from national meetings. *SERFF* is System for Electronic Rates and Forms Filing, *SBS* is State-Based Systems, *SVO* is Securities Valuation Office, and *IID* is International Insurers Departments.

The NAIC operates in the form of committees: Executive (EX), Life Insurance and Annuities (A), Health Insurance and Managed Care (B), Property and Casualty Insurance (C), Market Regulation and Consumer Affairs (D), Financial Condition (E), Financial Regulation Standards and Accreditation (F), International Insurance Relations (G), NAIC/Consumer Liaison, NAIC/Industry Liaison, and NAIC/State Government Liaison.

These committees have numerous task forces and working groups. Initiatives are addressed via conference calls throughout the year as well as at three national meetings per year.

2.3 National Conference of Insurance Legislators

The National Conference of Insurance Legislators (NCOIL) may be best described as a trade association of state legislators. While members of NCOIL are generally state legislators with an interest in insurance, NCOIL itself is not a regulator. The NCOIL's purposes are to educate state legislators, assist legislators from different states to interface, improve the quality of insurance regulation, assert the prerogative of legislators in making state policy, and speak on federal initiatives that attempt to encroach upon state primacy in overseeing insurance.

2.4 Department of Managed Health Care (California)

In a somewhat unique situation, most of California's health insurers are regulated by its Department of Managed Health care (DMHC). The DHMC helps California consumers resolve problems with their health plans and works to provide a more stable and financially solvent managed care system. However, the DMHC is not a member of the NAIC.

2.5 Federal Insurance Office

The Federal Insurance Office (FIO) was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The FIO monitors all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system. The Office coordinates and develops Federal policy on prudential aspects of international insurance matters, including representing the U.S. in the International Association of Insurance Supervisors (IAIS). The Office assists the Secretary in negotiating (with the U.S. Trade Representative) certain international agreements. The FIO's authorities extend to all lines of insurance except health insurance, long-term care insurance (except that which is included with life or annuity insurance components), and crop insurance. The FIO is empowered to ask for any type of data from any insurer.

The Office monitors access to affordable insurance by traditionally underserved communities and consumers, minorities, and low- and moderate-income persons. The Office also assists the Secretary in administering the Terrorism Risk Insurance Program.

The FIO is not a regulator or supervisor.

Its objectives are:

a) To provide insurance sector expertise to the Financial Stability Oversight Council (FSOC);
b) To focus on international issues, such as regulation and reinsurance; and
c) To work closely and consult with state insurance regulators.

The Federal Advisory Committee on Insurance (FACI) provides advice and recommendations to the FIO to assist the Office in carrying out its duties and authorities. FACI members are appointed by the FIO. FACI provides its advice and recommendations directly to the FIO.

2.6 Financial Stability Oversight Council

The FSOC was established by the Dodd-Frank act. Its missions are to:

a) Identify risks to the financial stability of the U.S. that could arise from the material financial distress or failure of large, interconnected banks or non-bank financial companies;
b) Promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties that the U.S. government will shield them from losses in the event of failure; and
c) Respond to emerging threats to the stability of the U.S. financial system.

The FSOC has fifteen members, ten of whom have voting privileges and five of whom do not. The ten include officials such as the Secretary of the Treasury, the chair of the Federal Reserve Board, the chair of the Securities and Exchange Commission, and the chair of the Federal Deposit Insurance Corporation, plus an independent member with insurance expertise. The five include the director of the FIO and one state insurance commissioner.

The Office of Financial Research (OFR) collects data and performs analyses for the FSOC.

2.7 Securities and Exchange Commission

The mission of this U.S. agency is to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation.

The Securities and Exchange Commission (SEC) impacts insurers in several ways. The SEC regulates the registration and public offering of shares of stock of public insurance companies. It also regulates insurance products deemed to be securities, such as variable annuity and variable

life products. Its regulation has to do more with the sales process and disclosures rather than valuation rules or principles. The SEC has delegated accounting authority for public registrants to the Financial Accounting Standards Board.

2.8 Federal Reserve System

The Federal Reserve, known informally as "the Fed," is the central banking system of the U.S. Its original three objectives were maximum employment, stable prices, and moderate long-term interest rates. Responsibilities have since expanded to include monetary policy, supervising banking institutions, maintaining stability of the financial system, and providing services to depository institutions.

The Dodd-Frank act empowered the Fed to supervise non-bank financial institutions that are deemed systemically important financial institutions (SIFIs). The FSOC determines which institutions are SIFIs.

2.9 Department of Labor

The mission of the U.S. Department of Labor is to foster, promote, and develop the welfare of wage earners, job seekers, and retirees; to improve working conditions; to advance opportunities for profitable employment; and to assure work-related benefits and rights. Among its many initiatives and responsibilities that impact insurers are: equal employment opportunity; health plans and benefits; retirement plans, benefits, and savings; unemployment insurance; workers' compensation; and the Affordable Care Act.

2.10 Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) is the federal agency that holds primary responsibility for regulating consumer protection with regard to financial products and services in the U.S. It was created by the Dodd-Frank act; it is located inside and funded by the United States Federal Reserve, with an interim affiliation with the U.S. Treasury Department. The bureau is tasked with the responsibility of promoting fairness and transparency for mortgages, credit cards, and other consumer financial products and services. The central mission of the CFPB is "to make markets for consumer financial products and services work for Americans—whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products."

The business of insurance has been expressly excluded from the list of financial products and services that are within the jurisdiction of the CFPB. The CFPB is prohibited from exercising enforcement authority over a person regulated by a state insurance regulator other than a few limited exceptions to this general prohibition.

SECTION 3. INSURANCE REGULATION IN MEXICO

With one exception, regulation and enforcement for the insurance industry is at the federal level within the Ministry of Finance and the Insurance and Surety National Commission (CNSF, *Comisión Nacional de Seguros y Fianzas*). The only exception is that some states mandate the purchase of auto (or other) insurance coverage or require a minimum benefit such as death due to a car accident. The states will not define its features or monitor the solvency of the provider. There is almost negligible enforcement via class action venues. Since the sole mandate for the federal regulator is to ensure companies remain solvent, there are no minimum non-forfeiture laws. There is a federal agency (under the Ministry of Finance) called CONDUSEF that was established in 1999 for protecting financial service users, including insurance issues (mainly regarding some general guidelines for health insurance, compulsory clauses, and giving recommendations for the improvement of insurance contracts). Major markets include a life and savings market with a focus on endowment-type products; a large, voluntary auto market; and an individual and group health market. The main focus of general insurance coverages is business and commercial products. There is very little coverage of homeowners', hurricane, and other disaster exposures.

On the whole, insurers support the general framework of the 1999 law. Adaptions by Mexico have avoided the political and technical compromises (often encountered in the U.S. and the European Union, or EU) leading to a colloquial title of "Solvency Dos" for the insurance law.

The insurance regulator is knowledgeable and well-respected by the other financial regulators and by the industry on its surveillance function. It is perceived as lacking a mandate and interest to contribute to the industry growth. For example, it has been very difficult to develop new markets such as microinsurance or telemarketing. The insurance regulator is seen as a peer to banking and other bodies. Mexico has had historically conservative life reserve requirements.

The CNSF has a strong federal presence and serves as an equal member of the Mexican Stability Council along with Supervisors of Pensions, Finance, and Banking, the Ministry of Finance, and the Central Bank. The CNSF has a central office in Mexico City with about 380 employees plus five regional offices for licensing agents.

3.1 Key Functions

3.1.1 Licensing Companies

New formations must go through the Finance Ministry for approval. The market has been growing fast (9 percent a year in nominal terms, 6.7 percent a year in real terms) over the last twelve years. The direct premium of the market has increased threefold (from 104,965 million pesos in 2000 to 308,257 million pesos in 2012). Major growth has been in life insurance with a savings component. Fifty-six percent of the insurers in Mexico have international ownership and 44 percent are locally owned. Company licensing is perceived as a more political, or rather bureaucratic, process. Officials there face the challenge of less familiarity with insurance and likely no actual past personal contact with the applicants. It may take between half a year to a year to obtain an approval. Still, a number of important new companies have emerged. There are now 103 licensed insurers, of which about eighty are members of the trade group AMIS. In 2000, there were seventy insurance companies. Considering that companies left the market, it means an important incremental effort has occurred to create a number of new insurance companies.

3.1.2 Licensing Agents

Broker exams are seen as rigorous and are not a trivial process. Agent licensing is more straightforward; there is neither a continuing education nor recertification process if the agent obtains more than 8/10 on the qualification test.

3.1.3 Approving Products

Mexico has moved to a file and use system. In the past, it might take as long as two years to have a product approved. Now, the regulator has thirty calendar days to make comments from the date of official filing. If there are no comments after this period the product is "registered". However, the product can still be reviewed again at a later date.

3.1.4 Examination of Market Conduct

The chief point of focus for the past five years has been Article 140, governing money laundering activities.

3.1.5 Solvency Oversight

About 120 CNSF employees are focused on surveillance. They do an on-site examination once every two years. About half of the staff are actuaries with the rest having accounting and economic backgrounds. The exams are risk-focused and staff has leveraged information from these exams to go back and reassess approved products.

3.1.6 Prospective Risk Oversight by CNSF

In 1989, Mexico had a structure very similar to Solvency I in Europe. Steps toward a new structure were enacted in 2006 with a new insurance and bonds law, the so-called Solvency Dos. This law is akin to Solvency 2. It includes a requirement for dynamic solvency testing (DST) for both life and P&C companies. The intent was to create a forward-looking corporate risk culture. The next phase of the law, which has been in process since 2007, is to mandate an economic balance sheet and include stress testing (Own Risk and Solvency Assessment, or ORSA) and the use of risk models (based on either standard formulas or internal models) along the lines of the Swiss Solvency Test. The expectation is to have a two-year horizon for DST and use the next three years' business plan. The goal is to see who is vulnerable to which factors. The regulator would mandate the stress tests, which would be updated each year. Final implementation measures are being discussed and expected to be published in August or September of 2014 with the new laws effective in April of 2015.

The CNSF is also intending to create a regulator internal model that can be used to project the balance sheet and solvency situation of the reporting entities.

What is currently in place then is more like what could be called a Solvency 1.5. The rest of Latin America is waiting to observe and learn from the Mexican implementation before proceeding with their local regulatory modifications.

This regulatory framework relies heavily on the role of the actuary, which correlates positively to the fact that about half of the current CNSF staff are actuaries.

3.1.7 Taxation of Insurance

Similar to the U.S., taxation of insurance accumulation products is not avoided but deferred.

3.2 Impact of Regulation on Corporate Governance

One response to the new Insurance and Bonds law has been to define a risk function oversight responsibility to the board, although not necessarily a chief risk officer (CRO) role. Where the function exists, he or she is normally part of the integrated control function and is responsible for the new law implementation. In this case, the CRO is a peer to the chief counsel, chief financial officer, and the chief operating officer. The CRO reports to the board of directors as well as to the chief executive officer (CEO). The CRO reviews the effectiveness and appropriateness of risk controls everywhere in the company. This is in contrast to the internal audit function, which only ensures controls are in place and that they work.

In addition, many companies have had a family ownership, so the laws have helped clarify and change the expectations of board members.

SECTION 4. INSURANCE REGULATION IN CANADA

In Canada, insurance is regulated primarily at the federal level with some supervision occurring at the provincial level.

4.1 Provincial

There are two major areas of supervision that are delegated to the Provinces. The first is that of market conduct and the other is the setting of auto insurance rates.

In addition, there are many, smaller provincially-regulated insurance companies. Most of these companies have their headquarters in the province of Québec. A vast majority of these companies are regulated by the *Autorité des Marchés Financiers* (AMF), the provincial regulator in Quebec.

The AMF is the body mandated by the government of Québec to regulate the province's financial markets and provide assistance to consumers of financial products and services.

Established under an act respecting the AMF on February 1, 2004, it is unique by virtue of its integrated regulation of the Québec financial sector, notably in the areas of insurance, securities, deposit institutions (other than banks), and the distribution of financial products and services.

In addition to the powers and responsibilities conferred on it by its incorporating legislation, the AMF oversees the enforcement of laws in each of the areas it regulates. It can also draw on self-regulatory organizations (SROs), to which certain regulatory powers are delegated.

The AMF is financially self-sufficient through the fees and dues paid by the persons and firms governed by the legislation it is charged with enforcing.

4.2 Federal

The Office of the Superintendent of Financial Institutions (OSFI), created in 1987, is an independent agency of the Canadian government established to contribute to public confidence in, and the safety and soundness of, the Canadian financial system. OSFI supervises and regulates federally registered banks and insurers, trust and loan companies, cooperative credit associations, fraternal benefit societies, and private pension plans subject to federal oversight. OSFI ensures that they are complying with their governing legislation. Further high-level details on this regulator can be found at http://www.osfi-bsif.gc.ca/Eng/Docs/osfi_bch.pdf.

OSFI's mandate is to prevent undue loss to policyholders while promoting a competitive market. As an integrated regulator, OSFI oversees a market where banking sector problems are likely to be resolved faster while insurance problems typically take longer to emerge and resolve.

4.2.1 Key Functions

OSFI is an integrated regulator and only does financial oversight. Market conduct (the licensing of agents and product approvals) is overseen at the provincial level. OSFI's integrated structure works well since there are basically three major insurers (one has a bank license) and six major banks all with their corporate headquarters in Toronto. The largest bank (Royal Bank of Canada) also has life and P&C business. In aggregate, OSFI supervises and regulates over 400 banks and insurers as well as about 1,200 federally registered private pension plans.

OSFI chairs and is a participant in the Financial Institutions Supervisory Committee (FISC), whose members are OSFI, the Department of Finance, the Bank of Canada, the Canada Deposit Insurance Corporation (CDIC), and the Financial Consumer Agency of Canada (FCAC). They meet on a

quarterly basis to a) facilitate the exchange of information on matters relating to the supervision of federally regulated financial institutions to ensure there is not duplication of regulatory oversight, b) discuss cross-sector issues, and c) convey what actions are currently being contemplated.

4.2.2 Activities

As of March 31, 2013, OSFI employed 660 people in offices located in Ottawa, Montréal, Toronto, and Vancouver. They are devoted to the following tasks described in the subsequent subsections.

4.2.2.1 Operations Support

About 15 percent focus on corporate services such as IT support, human resources, and facilities management. OSFI recovers all of its costs, which in 2012–2013 totalled $127.7 million, through assessments. OSFI is funded mainly through asset-based, premium-based, or membership-based assessments on the financial services industry and a user-pay program for selected services.

4.2.2.2 Solvency Oversight

More than half are focused on supervision. This includes examiners who focus on relationship management, day-to-day or quarterly issues, and the examination of companies. This also includes a group of twenty-five actuarial specialists who spend about 60 percent of their time on resolution of supervisory activities such as advising or consulting on supervisor solutions and remedies to ensure they are sound. They also assist with the examinations that face atypical situations and/or subjects.

4.2.2.3 Prospective Risk Oversight

The rest of the staff is assigned to regulatory policy and development. The mandates are described in the subsequent subsections.

4.2.2.3.1 Capital Issues

About a third of them are devoted to capital issues. Current top priorities are capital for mortgage insurance, variable annuities, and internal model approval.

4.2.2.3.2 Accounting Policy

This includes understanding not only primary but also second- and third-order impacts that regulation has on the market place. In a 2009 speech, the Superintendent discussed unintended consequences of regulatory reforms by saying, “Finally, a big lesson from the crisis is that there are *unintended consequences* associated with every policy, regulation, or decision. Globally, historically low interest rates, mortgage practices that allowed more and more people to buy houses, and cutting red tape via less regulation, all had unintended consequences.” More on this viewpoint can be found at http://www.osfi-bsif.gc.ca/eng/docs/nicc09.pdf.

4.2.2.3.3 Research

A current initiative is research on corporate governance. This echoes the Basel priorities of addressing mortgage insurance, influencing international issues such as liquidity tests, leverage ratios, counterparty risk, securitization, trading books, and operational risks.

4.2.2.3.4 Product Review

A review of new products occurs regularly to assess what new risks they might pose.

4.2.2.3.5 Emerging Risks

An Emerging Risk Committee functions within the supervisory section. It provides a quarterly confidential internal report on the top risks, compiled via interviews with all areas of OSFI. This quarterly report lists the top five risks to OSFI. Number one will typically be the economy, but will also include the ability to attract and retain employees with sufficient talent so it can meet its legislative mandates. For example, retaining suitable employees may mean expertise in policy and not supervision or vice versa. Other risks noted can include emerging risk concentrations and new products.

These reports then become the basis for the regulator's annual public OSFI Plans and Priorities, which summarize the issues and risks that OSFI will be examining. The most recent one can be found at http://www.osfi-bsif.gc.ca/eng/osfi-bsif/rep-rap/pp/pages/pp1316.aspx.

4.2.2.3.6 Feedback from Those Regulated

OSFI conducts regular surveys, through an independent consultative process, with the various entities within its mandate to assess its performance as a prudential regulator and supervisor, as perceived by its regulated companies. Previous consultation survey results can be found at: http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/rep-rap/srv-sdg/Pages/default.aspx.

SECTION 5. OTHER ORGANIZATIONS, NATIONAL AND INTERNATIONAL, WITH SIGNIFICANT INFLUENCE ON INSURERS

There are many organizations outside of national insurance regulators that impact the financial health of insurers.

5.1 Standard-Setters

5.1.1 Financial Accounting Standards Board

Based in Norwalk, Connecticut, the Financial Accounting Standards Board (FASB) establishes standards of financial accounting that govern the preparation of financial reports by nongovernmental entities in the U.S. Its standards are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants (AICPA).

5.1.2 International Accounting Standards Board

The International Accounting Standards Board (IASB) promulgates accounting code for international financial reporting standards that apply to companies around the world. The London-based IASB cooperates with many political bodies such as the EU, FASB, and IAIS. Jurisdictions that have currently accepted these standards as binding in their country include the EU, Argentina, Brazil, Canada, Chile, Israel, Korea, Mexico, Russia, Taiwan, and the Ukraine.

5.1.3 International Association of Insurance Supervisors

Based in Basel, Switzerland, the IAIS promotes effective and globally consistent supervision of the insurance industry and fosters financial security. The IAIS has developed twenty-eight Insurance Core Principles. These ICPs are used by local jurisdictions to develop supervisory policy, and by the International Monetary Fund (IMF) in its Financial Sector Assessment Program (FSAP). Even though they are non-binding, the ICPs serve two purposes. One is to provide a template and training opportunity for regulatory bodies in emerging countries. The other is to recommend uniform global approaches to insurance supervision. The IAIS has also just taken on three major projects recently requested by the Financial Security Board. One is included in its development of the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), on an international capital and valuation basis, to be completed around 2018. ComFrame will also develop processes for supervising internationally active insurance groups (IAIGs), establishes a comprehensive framework to address group activities and risks, sets grounds for supervisory cooperation, and fosters global convergence of measures and approaches. The other two projects are to complete in 2014 a global capital backstop (GCB) requirement for SIFIs and to complete in 2015 a higher-loss absorbency requirement to accompany the GCB.

5.2 Tax Authorities

The tax authorities establish reporting basis and taxation rates for its constituents. In the U.S., the Internal Revenue Service establishes the accounting basis by which insurers file their tax returns. In Canada, the taxation accounting basis is the same as that used for regulatory and for shareholder purposes. The amount and incidence of taxation, to both the insurer and the policyholder, is critical in the product development cycle.

5.3 Nationally Recognized Statistical Rating Organizations

Nationally recognized statistical rating organizations (NRSROs) are firms that issue credit ratings. Rating agencies issue credit ratings based on the financial strength of insurers as well as on the

relative financial strength of individual securities. In the U.S., agencies recognized by the SEC are deemed NRSROs. The SEC and NAIC allow financial institutions to use these ratings in the course of determining solvency requirements. These ratings may be used to determine discount rates for solvency determination in Europe. The most well-known NRSROs in the insurance industry are A M Best, Standard & Poor's (S&P), Moody's, and Fitch. The NRSROs visit insurers regularly to discuss financial health, business plans, risk management, and governance. The ratings these firms issue are extremely important to insurers. Internationally, they play an essential role in the benchmarking of financial strength for regulators, particularly when it comes to reinsurers that are not licensed locally.

5.4 Accounting Firms

In the U.S., an insurer is usually required to hire a public accounting (CPA) firm to provide an opinion on its statutory financial statements within six months of year-end. The statutory accounting opinion covers the balance sheet and income statement but not the supporting exhibits. Thus, the CPA firms need to be in general concurrence with the insurer's accounting and valuation practices.

Companies with a significant number of shareholders are also required to file audited financial reports. The accounting basis used for this purpose is called general purpose. In the U.S., the basis is Generally Accepted Accounting Principles (GAAP). Other jurisdictions will employ International Financial Reporting Standards (IFRS) as the accounting basis for communicating with shareholders.

5.5 Public Company Accounting Oversight Board

The Public Company Accounting Oversight Board (PCAOB) is a non-profit corporation established by the U.S. Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports. The Sarbanes-Oxley Act created the PCAOB in 2002. Sarbanes-Oxley required that auditors of U.S. public companies be subject to external and independent oversight. Previously, the profession was self-regulated. The five members of the PCAOB are appointed to staggered five-year terms by the SEC after consultation with the Federal Reserve System and the Secretary of the Treasury. The SEC has oversight authority over the PCAOB, including the approval of the Board's rules, standards, and budget. PCAOB activities are funded primarily through annual fees assessed on public companies in proportion to their market capitalization and on brokers and dealers based on their net capital.

5.6 Actuarial Standards Board

The Actuarial Standards Board (ASB) establishes actuarial standards of practice (ASOPs) to provide actuaries with guidance as to which standards might apply as they perform various assignments in their roles as actuaries. ASOPs are updated periodically; the actuary is responsible for keeping current with changes to the ASOPs and ensuring that professional services rendered by the actuary satisfy the current version of each applicable ASOP.

5.7 Actuarial Board for Counseling and Discipline

The Actuarial Board for Counseling and Discipline (ABCD) investigates reported violations of the ASOPs (or professional code of conduct) by actuaries practicing in the U.S. and makes recommendations to the various actuarial organizations as to the appropriate discipline.

5.8 Actuarial Public Policy Organizations

5.8.1 American Academy of Actuaries

The American Academy of Actuaries (AAA), based in Washington, DC, is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. It also sets qualification, practice, and professionalism standards for actuaries credentialed by one or more of the five U.S.-based actuarial organizations. The academy advocates on behalf of the profession and promotes the use of actuaries in non-traditional industries.

5.8.2 Canadian Institute of Actuaries

The Canadian Institute of Actuaries (CIA) is the Canadian organization of the actuarial profession. The CIA serves both the public interest and the actuarial profession by establishing and maintaining professional guidance, relevant research, quality education, and validations of eligibility. It maintains a code of conduct and a disciplinary process. It makes meaningful and timely contributions to public policy. The CIA has about 4,000 members.

5.8.3 Asociación Mexicana de Actuarios

The *Asociación Mexicana de Actuarios* (AMA) participates in activities that promote the growth of the actuarial profession and the insurance industry in Mexico. It supports the professional development of the actuarial profession and organizes work sessions, training sessions, and conferences to discuss topics related to the actuarial profession.

The AMA promotes research studies that contribute to the development of the insurance industry in Mexico and proposes changes to insurance laws that ensure regulation is adequate for the Mexican insurance industry. It proposes new or amendments to study programs to keep current actuarial designations.

The AMA establishes adequate channels to a) promote the initiatives of the AMA to encourage participation of its members, b) mentor actuarial students working towards an actuarial designation, and c) recruit and attract new members. It works in conjunction with the *Colegio Nacional de Actuarios* (CONAC) on issues relevant to the insurance industry, and provides education so members can meet continuing professional education requirements.

The AMA has about 300 members.

5.8.4 Colegio Nacional de Actuarios

CONAC is the organ of integration for Mexican actuarial professionals and their various specialized sectors, including the AMA and the *Asociación Mexicana de Actuarios Consultores* (Mexican Association of Consulting Actuaries). CONAC aims to promote excellence in professional development, protect and develop the professional field of actuarial work, promote competitiveness, and ensure optimum national and international projection of the actuarial profession, based on adherence to the highest principles of professional ethics.

Actuaries become qualified to practice, in general, through university studies in 17 universities with curricula that CONAC reviews. CONAC also makes recommendations so it complies with the International Actuarial Association (IAA) syllabus. Although not compulsory, CONAC

recommendations in general are well received by universities, which usually modify curricula to comply.

In particular, for the actuarial function in insurance companies including reserve valuation and adequacy analysis and product development, a certification is needed. Another (separate and independent) certification is needed for pension plans valuation.

CONAC has certification, continuing education, standard development, and disciplinary processes in place for the insurance and pensions certifications described.

5.8.5 International Actuarial Association

The IAA represents the profession to other international organizations, develops education standards, and encourages research in order to address changing needs. The IAA is an association of about ninety actuarial organizations from around the world. It can also issue international standards of practice (ISAPs), which are model standards that may be adopted by member associations. These standards may apply to international practitioners regardless of whether they have been adopted in local countries. For example, it is plausible that the actuary of a U.S. company that is owned by an overseas corporation may need to comply with both local and international standards.

5.9 Trade Organizations

Trade organizations represent their members' interests and are frequent and important providers of input and testimony to public policy on particular regulation.

5.9.1 American Council of Life Insurers

The American Council of Life Insurers (ACLI) represents over 300 life insurers and fraternal benefit society member companies operating in the U.S. Member companies represent more than 90 percent of assets and premiums of the U.S. life insurance and annuities industries. The ACLI is headquartered in Washington, DC.

5.9.2 Property Casualty Insurers Association of America

The Property Casualty Insurers Association of America (PCIAA) is a P&C industry trade association that promotes and protects the viability of a competitive private insurance market for the benefit of customers and insurers. It advocates at the state, federal, and judicial levels. It is headquartered in Des Plaines, Illinois, and has ten regional offices.

5.9.3 National Association of Mutual Insurance Companies

The National Association of Mutual Insurance Companies' (NAMIC) 1,400-member companies write all lines of P&C insurance business and include small, single-state, regional, and national carriers accounting for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market. NAMIC's offices are in Indianapolis, Indiana, and Washington, DC.

5.9.4 American Insurance Association

The American Insurance Association (AIA) is an industry advocate for over 300 P&C insurers. The AIA has six regional offices and serves as a resource for policy makers, the media, and the public on the state, federal, and international landscapes.

5.9.5 Reinsurance Association of America

The Reinsurance Association of America (RAA), headquartered in Washington, DC, is the trade association for P&C reinsurers doing business in the U.S.

5.9.6 Canadian Life and Health Insurance Association

The Canadian Life and Health Insurance Association (CLHIA) represents the collective interests of its member life and health insurers. The CLHIA represents 99 percent of the life and health insurance policies in force in Canada.

5.9.7 Asociación Mexicana de Instituciones de Seguros

The *Asociación Mexicana de Instituciones de Seguros* (Mexican Association of Insurance Institutions, or AMIS) comprises 80 percent of the insurance companies of Mexico and produces 98 percent of total premiums. Its aim is to promote the development of the insurance industry. AMIS works to encourage people to have access to mechanisms of protection against the risks to which they are exposed. AMIS represents the interests of insurers to public sector authorities, private and social. It also provides technical support to its partners, who disseminate and promote knowledge of insurance, the culture of risk prevention, and financial education among Mexicans. AMIS is headquartered in Mexico City.

5.10 Other Organizations

5.10.1 International Monetary Fund

The IMF, headquartered in Washington, DC, is an organization of 187 countries working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. It is the sponsor of the FSAP. The FSAP's focus is to gauge the stability of the financial sector and to assess its potential contribution to growth and development. This review certifies that a jurisdiction's insurance regulatory process is acceptable according to accepted international standards. The FSAP examines the soundness of financial sectors; conducts stress tests; rates the quality of bank, insurance, and financial market supervision against accepted international standards; and evaluates the ability of supervisors, policymakers, and financial safety nets to respond effectively in case of systemic stress.

5.10.2 World Bank

The World Bank (WB), headquartered in Washington, DC, is an international financial institution that provides loans to developing countries for capital programs. The WB is owned by its 187 member countries and was established in 1944. Its mission is to fight poverty and to help people help themselves. The World Bank offers technical assistance to regulators in developing countries working on improving their insurance supervisory frameworks.

5.10.3 Office of Economic Cooperation and Development

The Office of Economic Cooperation and Development (OECD) promotes policies to improve the economic and social well-being of people around the world. Established in 1961, the OECD has thirty-four country members. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. The OECD works with governments to understand the drivers of economic, social, and environmental change. They measure productivity and global flows of trade and investment. They analyze and compare data to

predict future trends. They set international standards on a wide range of areas, from agriculture and tax to the safety of chemicals.

5.10.4 Joint Forum

The Joint Forum (JF) was established in 1996 under the aegis of the Basel Commission on Banking Supervision (BCBS) (bank regulators), the International Organization of Securities Commissioners (IOSCO) (securities regulators), and the IAIS to deal with issues common to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. The JF is composed of an equal number of senior bank, insurance, and securities supervisors representing each supervisory constituency.

5.10.5 Geneva Association

The Geneva Association (GA) identifies fundamental trends and strategic issues that impact the insurance sector. Its official title is the International Association for the Study of Insurance Economics. Based in Geneva, Switzerland, it is a non-profit organization funded by its members. The GA membership comprises a statutory maximum of ninety CEOs from the world's top insurance and reinsurance companies.

5.10.6 Financial Stability Board

The Financial Stability Board (FSB) coordinates, at the international level, the work of national financial authorities and international standard-setting bodies and develops and promotes the implementation of effective regulatory, supervisory, and other financial sector policies. The FSB was created by the G-20. Senior representatives of financial authorities, international financial institutions, standard-setting bodies, and committees of central bank experts comprise the FSB leadership. It is headquartered within the Bank for International Settlements (BIS) in Basel.

5.10.7 European Insurance and Occupational Pensions Authority

The European Insurance and Occupational Pensions Authority (EIOPA) supports the stability of the financial system, transparency of markets, and financial products as well as the protection of insurance policyholders, pension scheme members, and beneficiaries. It advises the European Commission (EC) on insurance, reinsurance, and pension matters. Formerly known as CEIOPS, EIOPA is the primary driver of Solvency II, a solvency regime for insurers being introduced in Europe and in other countries around the world. This body is composed of regulators and is based in Frankfurt.

5.10.8 European Commission

The main goal of this college of commissioners is to improve the regulatory environment in the EU. All initiatives must equally represent the common good to all EU countries. The EC is responsible for enacting common EU policies and for managing budgets of the EU. Based in Brussels and Luxembourg, membership comprises one commissioner from each EU country.

5.10.9 American Institute of Certified Public Accountants

The AICPA is the world's largest association representing the accounting profession. AICPA members represent many areas of practice, including business and industry, public practice, government, education, and consulting. The AICPA sets ethical standards for the profession and U.S. auditing standards for audits of private companies, non-profit organizations, and federal, state, and local governments.

5.10.10 Office of Foreign Assets Control

The Office of Foreign Assets Control (OFAC), a department of the U.S. Treasury, administers and enforces economic sanctions programs primarily against countries and groups of individuals such as terrorists and narcotics traffickers. U.S. persons and corporations cannot engage in prohibited transactions unless authorized by OFAC or expressly exempted by statute. The sanctions can be either comprehensive or selective, using the blocking of assets and trade restrictions to accomplish foreign policy and national security goals.

5.10.11 Financial Industry Regulatory Authority

The Financial Industry Regulatory Authority (FINRA) is the largest independent regulator of securities firms doing business with the public in the U.S. Its mission is to pursue investor protection and market integrity. FINRA carries out its mission by overseeing virtually every aspect of the brokerage industry. It oversees about 4,250 brokerage firms, about 162,155 branch offices and approximately 629,525 brokers. Its authority is delegated to it by the SEC.

5.10.12 Security Investors Protection Corporation

The Security Investors Protection Corporation (SIPC) is a federally mandated, non-profit, member-funded, U.S. corporation. It protects investors in certain securities from financial harm if a broker-dealer fails. It does not protect against losses in the securities markets, identity theft, or other third-party fraud. SIPC is neither a government agency nor a regulatory authority. It is a nonprofit, membership corporation, funded by its member securities broker-dealers.

SECTION 6. REGULATORY RISK EXAMPLES

This section describes examples of regulatory risk gathered from a number of sources. The examples collected from regulators and industry divided fairly evenly between the pros and cons of too much or too little regulation, focusing on the impact to either the policyholder (and/or claimant) or the shareholder. There are several reasons for this lack of uniform advocacy by regulators and industry:

a) Depending on the example, some industry participants might actually be for more regulation in the interest of a level playing field, maintaining a viable respected market, or safeguarding against areas where making a business or risk judgment about an unknowable situation might be later second-guessed by shareholders or supervisors.
b) Regulators can have a dual mandate to both maintain protection for existing policyholders (and claimants) and to maintain a competitive market for the benefit of new policyholders. Thus a regulator must strike a balance (either consciously or implicitly) between protecting current versus future policyholders.
c) Both regulators and companies have conflicting desires for prescriptive rules and for more open-ended principles. This occurs across and within both companies and regulatory jurisdictions. Regulators like rules that provide legal grounds to exercise their powers. Industry likes rules that can reduce the uncertainty of its business operations. Ambiguity of legal requirements hinders the clean execution of a firm's strategy, which is essential to its success in the market.
d) As new risks and product opportunities emerge, the market will innovate with revised products and regulators may "innovate" with revised or new rules. Yet the introduction of rules will change the risk behaviors and risk exposures of the participants, sometimes leading to a sounder market and sometimes undermining the original intent behind the rules. The ability (and powers) to deal with emerging risks is at the heart of the current focus on systemic risk regulation and its objective to have authority to deal with issues that may not have been contemplated in prior laws.

6.1 Gaps Between Legislation and Supervision

Instances: In one Asian country, the regulator has issued (with annual updates), a 1,500-page book on how an insurance entity needs to operate. This covers all aspects of operations, such as claims payments, risk management, financial reporting, and governance. During examinations, the regulator will look for violations against any of the regulations prescribed in the 1,500 pages. At the end of the examination, the company is presented a bill comprising fines (whose rate schedule is unpublished) for all observed violations.

Nearly all employees work under the cloud of adherence to the detailed supervisory specifications. This is viewed as creating an undue, distracting focus on the smallest of applications and procedures. It also adds costs and discourages innovation by the insurer since the regulator has to first write all the rules to allow it.

In the U.S., a common complaint from industry participants and observers is that the Dodd-Frank Act, in its 1,200 pages, essentially left many of the detailed actual company reporting and procedural requirements to the supervisory bodies. This will generate an anticipated several thousand more pages of requirements with an unknown impact on the marketplace. Many have

cited this "lack of developed rules" as also discouraging innovation due to the regulatory uncertainty it brings. The (substantial) cost of this will ultimately be borne by the consumer.

Similarly, for complex topics, legislatures sometimes need more than a single session to develop and pass new legislation. When this occurs, a great degree of uncertainty is introduced up until the legislation is passed, such as happened with the last revision of the U.S. insurance tax code. The tax authorities proposed new regulation for the taxation of insurance companies in 1983. This legislation contained major revisions to the tax code. Consequently, new product development, new reinsurance treaties, sales of blocks of business, and mergers/acquisitions ground to a halt for a one-year period. This is also true for the development of new accounting regimes, as when future reporting paradigms are in development, insurers will not know the emergence of earnings or the required reserve level.

Insurer perspective: It is extremely difficult to operate where there is regulatory unpredictability.

Regulator perspective: Regulators have a challenging mandate. They must execute the will of the legislature. But this is challenging when the law regulates a complex topic that may not be fully grasped by the legislature. This makes it harder to reduce uncertainty while also increasing the risk of unintended consequences due to the lack of understanding by the legislators.

6.2 Segregated Funds in Canada

Instance: A market innovation for the past twenty years in Canada has been the marketing of investment funds with some guarantees offered by insurers. These products have low-frequency, high-impact risk that needs to be monitored and managed. Since before 2000, regulators have been hoping to see better enterprise risk management (ERM) governance applied to the management of these funds and have provided some guiding principles on how they will evaluate the firms' practices.

Insurer perspective: The consistent response from industry participants in Canada has been an expectation of a compliance-focused set of detailed rules and criteria so they will know what they need to do to be viewed favorably by the regulators, implying that the company expects the regulator to be better at recommending sound risk management practices. While additional regulatory requirements are an additional company cost, in the U.S., the class action ability to pursue matters civilly means companies are often more at risk due to imprecise or ambiguous legal requirements. As a result, they hope to mitigate legal risk exposure through more rules-based requirements.

Regulator perspective: Regulators often also like having clear rules so they can exercise their unique regulatory tools without facing time-delaying and unproductive legal challenges. However, this practice can also stifle innovation as prior rules become inefficient and/or ineffective due to changes in the outside world that could allow better products and/or coverages. There has also been the difficulty in predicting the upcoming products and associated compliance issues.

6.3 Too Many Regulators

Instance: In the U.S., insurers can face oversight from multiple supervisors. There are potentially three levels of authority: state, federal, and international. Importantly, they may have both overlapping as well as different legislative mandates/objectives.

a) At the state level an insurer is subject to each state insurance department in which it is licensed. It is also subject to attorney general actions as well as civil decisions that result

from class action suits where private lawyers judge that the current regulatory structure has been lacking in the ability to "prosecute" or execute the law due to a lack of resources.

b) While all companies will be subject to U.S. federal tax laws and IRS audits, a U.S. insurer will face additional regulations, evaluations, and supervising agencies if the insurer is designated a SIFI or is a member of an IAIG.

c) Writers of variable products will face SEC regulation of the products as well as state of domicile oversight.

d) While a U.S. insurer that is owned by a European parent will be facing reporting requirements imposed by the EU, the establishment of ICPs by the IAIS (and their use by the IMF in financial sector assessments) sets an implicit international regulatory requirement. In addition, the FSB established by the G-20 is creating additional pressure to have uniform international requirements.

Insurer perspective: It becomes very expensive to generate and report multiple evaluative measures. Also, it becomes a challenge to nurture open and effective relationships with so many diverse and independent regulators. This issue is compounded when it is the case that the individuals have more bank than insurance experience.

For example, in response to the 2008 financial crisis, several large insurers transformed themselves into bank holding companies, thus subjecting themselves to new and unfamiliar forms of regulation. One large company finished at the top of the list one year in the set of stress tests, failed the following year for unknown reasons, and then after failing was denied a request for a shareholder dividend increase. While most investors, policyholders and insurance regulators were not concerned about this insurer's ability to perform, the company did suffer reputational damage through uncomplimentary headlines and devoted significant resources to the situation.

A former Federal Reserve board chairman, Paul Volker, noted in June of 2013, "The simple fact is the U.S. doesn't need six financial regulatory agencies. It is a recipe for indecision, neglect and stalemate, adding up to ineffectiveness."

Additionally, to the extent that different insurers are subject to varying additional layers of regulation, some insurers will be at a competitive disadvantage when it comes to price for the policyholder and return to the shareholder. Some insurers will be subject to federal standards and others will not.

Regulator perspective: Regulators from each body feel they bring something to the table. The design of the system does not allow for them to consolidate or relinquish authority, since to do so may violate a required legislative mandate. For example, in 2013, the Federal Housing Finance Agency (FHFA), which regulates Fannie Mae and Freddie Mac, extended its reach into the lender-placed insurance market to attempt to ban fees and commissions on insurance the consumer is forced to buy. Though these policies had been approved by state insurance departments, another government agency intervened to attempt to regulate this type of insurance. While insurers had not expected to be subject to requirements for compliance with the FHFA, the regulator perspective was that if the law requires them to regulate then they have the obligation to do so. The U.S. system expects the courts to then relieve conflicting requirements and/or mandates.

6.4 Government Override of Prior Legislative Mandate

Instance: In 2011 several northeastern states notified insurers that they were not to apply hurricane deductibles (significantly higher than for other causes of loss) for Hurricane Irene claims, although

in some cases the contractual requirements for imposing the deductibles may have been met. Nearly all insurers complied. In 2012, Hurricane Sandy devastated many of the same states, and again insurers were told not to impose the larger deductibles. The National Oceanic and Atmospheric Administration did not follow its usual procedures in naming the storm, and much of the damage was caused after the storm had lost its hurricane strength. Given the precedent of 2011, and the uncertainty about meeting the contractual language for triggering the deductibles, insurers again complied with the order. These deductibles were designed to address tight market conditions (insurers had been withdrawing from areas where they were over-concentrated). Their catastrophe model results showed much higher loss potential for homeowners' insurance in coastal areas.

Insurer perspective: The regulatory fiat described above overrode policy provisions and what had been priced for in the product. In the end, this unallocated cost will be paid for by future policyholders of the company and perhaps shared somewhat by the shareholders. These pressures can be exerted from both the executive and legislative bodies with or without the legal authority to do so. The override of previously written contracts sets an important legal precedent that introduces more uncertainty into the marketplace.

Regulator perspective: In this case, regulators may be concerned about the health of this type of market, which may already be under stress. Compounding this concern, it is plausible that the state government (perhaps, through governor order) implements a short-term rule-changing solution without having a long-term plan to address the underlying conditions, if only to effect quicker claim settlements and fewer disputes. It is always the government's right to decide after the fact if it wants to redistribute the effects of outcomes. Some regulators will also be concerned with how it upsets the long-term viability of the insurance market which is dependent on proper fund redistribution based on agreements entered into beforehand for unknown outcomes.

6.5 Conflicting Policy with Other Agencies

Instance: In Taiwan, a significant regulatory risk is coordinating policy with other government agencies. Taiwan's Insurance Bureau increased the maximum percentage of assets that could be held in real estate. However, at the same time, Taiwan's Central Bank was trying to dampen the rapid increase in housing and real estate prices. The Insurance Bureau had to retract its authorization for higher real estate holdings shortly after its announcement in order to adhere to the Central Bank's desire not to create new sources for real estate and housing borrowing.

Insurer perspective: This is an example of too many regulators.

Regulator perspective: Conflicts with other agencies over authority is not an infrequent issue. Here, economic policy objectives conflicted with insurance regulation.

6.6 Conflicting or Overlapping Investigative Powers for Different Regulatory Authorities

Instances: Sales practices may be reviewed independently by multiple state insurance departments, by state attorney generals, and by FINRA and the SEC, each with different mandates, aims, timetables, and expertise.

Insurer perspective: It would be more efficient to prepare statements, documents, and other materials for single regulatory bodies so that they do not have to be prepared multiple times, with adjusted requirements for each scenario.

Regulator perspective: Each regulatory authority is responsible for upholding the legislative mandate it has been given and working with one another to coordinate and reconcile oversight

where applicable. As difficult as it is to create legislation and reporting requirements, coordination with other agencies would compound the process.

6.7 Privacy

Instance: In some countries, there are data privacy laws designed to protect people's identities from being misused. In some instances, people now have to explicitly grant permission before critical items may be shared with others.

Insurer perspective: This creates challenges for reinsurer pricing. No longer can the direct company provide name, date of birth, and a customer identification number (for example, a Social Security number) to the reinsurer without prior approval from the policy owner. This makes facultative placements much more difficult and it makes acceptance of regular new business riskier since you can no longer check for over-exposure for a single person.

Regulator perspective: The legislature increased privacy protection for its citizens but has either increased the cost of insurance or created additional risk for reinsurance companies.

6.8 U.S. State Variations in Life or Health Valuation Requirements

Instance: While the NAIC recommends valuation methods and assumptions that can be uniform across the U.S., they must be approved on a state-by-state basis. They are established or affirmed by legislation, regulation, or pronouncement. An actuarial opinion must be submitted in accordance with each individual state's requirements. This uniformity (or lack thereof) issue usually arises for innovative life product designs.

Insurer perspective: A valuation actuary must spend additional time to research how state requirements may vary. Companies generally want to calculate a single set of reserves that exceed the maximum of each state in which it is licensed. An actuary may be forced to prepare multiple actuarial opinions, reconciling reported numbers to those required by the state of filing. In some cases, different financial statements (blue books) are filed in different states for the same time period.

In addition, uncertainty may arise when guidance given at the NAIC level, such as through an actuarial guideline, is implemented and/or interpreted differently among the state regulating bodies. An actuarial guideline may be required in one state, suggested in another, and proscribed in a third with different interpretations being used in different states.

Regulator perspective: Regulators and the NAIC are generally aware of this inefficient situation, having promulgated uniform rules for investment accounting and risk-based capital, and are working to introduce tools to create uniform liability methods and assumptions. But in all cases, state legislatures and insurance departments are not required to adopt these uniform recommendations.

6.9 Product Approval Process

Instance: All insurers must have their products, and sometimes premium rates, approved by each state in which they do business. For individual health annually-renewable products, this usually includes a requirement for minimum loss ratios to be demonstrated (and approved) for initial and ongoing rate changes in the filings.

Insurer perspective: The development and approval process for state-specific policy forms, as well as their administration, can be expensive and unproductive. In the 1980s, one state mandated

gender-specific rates while a neighbor state insisted on unisex rates. For P&C insurers, the policy approval process varies significantly from state to state. The most accommodating view for the P&C insurer is a state that requires rates to be neither excessive nor inadequate and not unfairly discriminatory. The most market-friendly states allow insurers to use new rates without waiting for state approval, as long as they meet standards. Other states mandate prior approval of all rates, which can become as much a political as an actuarial issue. It is often a time-consuming process for any insurer to have policy forms approved. If rate increases on certain policy types, such as long-term care, are delayed or denied, the financial health of the insurer can be jeopardized. This can also cause problems of equity between classes of policyholders. While regulators may approve a product they have the legal right to later come back and disapprove in the future upon further review, including fines for the sale of products that violated state laws (one disincentive for innovation).

Regulator perspective: Sometimes it is a challenge for a regulator to have complete knowledge of what recent and current policy form approval practices are. A disapproved policy can always be modified and re-filed. An approval may later be retracted, but policies may have already been issued. A regulator will want to thoroughly understand the source of a need for a rate increase. Market disruption (for example, a steep increase on renewal policies) is a major concern for regulators. A regulator generally prefers to review filings prior to approving them. The "back-end review" permitted to the regulator in order to facilitate a "speed to market" objective is difficult for regulators. They lose the opportunity to get the insurer to make changes prior to implementation—after the fact, it would be unlikely that an insurer would agree to withdraw a filing unless something was clearly illegal. For rate filings in some states, regulations allow rate increases up to a certain level without prior approval (for example, in New York it is 5 percent for private passenger auto and up to 15 percent for other lines).

6.10 Mandated Minimum Loss Ratios on Health Products

Instance: The NAIC model law in the U.S. has a requirement that rate increases must be justified through experience that exceeds a threshold minimum loss ratio, though this requirement has not been adopted in all states and group health products may be exempted. The Affordable Care Act (ACA) now includes a requirement that insurers not meeting the minimum loss ratio defined by the ACA must refund premiums.

Insurer and regulator perspective: There is a significant amount of state and company resources spent on the preparation, filing, and review of rate increase requests. While limits on rate adjustments will save money for today's policyholders, if limits are too severe, there may no longer be a viable market for future desired policyholders, or such policyholders may bear additional costs if resulting lower margins lead to failures and less overall capital. In addition, regulators can expect changing benefit design and coverage from industry participants to address the outcomes of such reviews.

6.11 Failure to Communicate with Regulator

Instance: In 2013, in the UK, a major insurer was fined 30 million euros by the Financial Services Authority (FSA) for not providing sufficient notice to the authority of the insurer's plan to make a major acquisition in Asia.

Insurer perspective: The insurer was aware of the obligation to keep regulators informed but at its most recent meeting with the authority, held to discuss plans for growth in Asia and raising capital, the company viewed this deal as highly unlikely and did not mention it.

Regulator perspective: Fifteen days after the meeting to discuss growth in Asia, the regulators were surprised by the breadth and depth of the plans to expand. According to the regulations, the supervisor should have been informed "at the earliest opportunity . . . to decide whether to approve or reject the deal on regulatory grounds." The regulators felt the company failed to deal with the FSA in an open and cooperative manner. They learned about the proposed acquisition in the press.

6.12 Risk Pooling

Instance: Insurers use rating categories to identify the riskiness of policyholders and an appropriate premium to charge. This segmentation results in those people with similar risks paying a similar premium. It can prevent an unfair subsidy from one class to another and helps manage/mitigate an anti-selection spiral. Examples are non-smokers not subsidizing smokers; safer drivers not subsidizing more hazardous ones. But the acceptance of this type of segmentation can change over time. In other words, what was once considered fair by the industry and society may evolve into something perceived as unfairly discriminatory. For example, before 1960, U.S. companies were allowed to charge different premiums based solely on race of the insured. Meanwhile, in Europe it will no longer be acceptable to charge different rates based on gender. Another example occurred in 2013, when exchange polices under the U.S. ACA resulted in higher rates for healthier people as they subsidized the costs of less healthy people. For P&C business, there is a new development in risk classification from a regulatory perspective. The increasing use of generalized linear models for risk classification has led to some very complex rate filings, with the resulting rates often very different from the rates they are intended to replace. Furthermore, insurers often wish to use credit scores in setting rates for new business and regulators vary in their acceptance of this criterion.

Insurer perspective: Introducing rate classification is conceptually a fair way to treat policyholders. Generally, the more rating classes that exist, the less chance there is for anti-selection. To use certain types of risk classification, insurers have been asked for extensive statistical support, for assurances that consumers are made aware of the impact of credit scoring on their rates and to disclose that periodic review of credit scores will result in higher rates.

Regulator perspective: We must keep an eye on society's norms and ensure that insurers are following suit. Such major changes in philosophy are generally communicated and insurers will have years to prepare. For risk classification, regulators are concerned about a) understanding these type of filings, b) trying to make sure that objectionable risk characteristics are not included, and c) explaining the new rating plans to the public.

6.13 New York Insurance Market of the Late 1800s

Instance: The New York insurance market in the late 1800s was characterized by many issues that led to the development of much of our modern regulatory framework. These included:

a) The use of tontines, where survivors won out over those who left;
b) A lack of accounting standards to reveal whether (and how much) of an investor's funds were being siphoned for management purposes/compensation; and
c) Policy language that was confusing to policy holders, resulting in common misunderstandings of what their policy covered.

This led to some prominent company failures and some new regulations in 1908.

Insurer perspective: While unethical practices may not have been the norm for the industry at this time, the entire industry was viewed with great skepticism due to the lack of corporate transparency and the visible scandal and faults of some corporate individuals.

Regulator perspective: A high-profile investigation was launched in the early 1900s (the Armstrong Commission). Its findings were for the most part enacted into regulation in the state of New York, thus affecting more than 98 percent of all insurance coverages during that time period.

6.14 Failures of the 1980s Insurance Market

Instance: The failures of Baldwin United, Executive Life, and Mutual Benefit in the 1980s created the need for new regulations to include more forward-looking risk analysis, including the requirement of an actuarial opinion.

Insurer perspective: The failures of a few high-profile companies led to a Congressional investigation and to the issuance of the Dingell Report titled *Failed Promises: Insurance Company Insolvencies*. This marked the start of a period of more public awareness of insurance company solvency. Many of the affected companies also appreciated the need for these new, more risk-focused requirements. Due to both the general agency system as well as the industry's dependence on consumer confidence, insurers are reviewed in order to be solvent decades from now to meet obligations. Inadequate regulation that leads to large insolvencies is a negative for insurers.

Regulator perspective: This marked the start of a period requiring more prospective, risk-focused oversight and examination of insurance organizations. Regulators introduced cash-flow testing requirements and developed the role of the appointed actuary.

6.15 Canadian Change in Accounting Basis

Instance: Canada has strived to maintain a single accounting basis for its solvency, shareholder, and taxation needs. Recently it changed its sole reporting basis from a proprietary Canadian method to an approach recognized worldwide, IFRS.

Insurer perspective: Generally, preparers and users were relatively satisfied if not fond of the prior basis. It is always expensive to convert to or introduce another accounting basis. It takes years to understand, embrace, and manage with a new accounting basis. A transition can be a dilemma to management, as earnings yet to be reported on the old basis (for example, conservatism embedded in liabilities) may now be considered already reported (these funds now represented in opening retained earnings). Thus, there are no shareholder earnings or employee bonuses (if based on earnings) on these evaporated profits. Conversely, earnings that have already been reported may now be re-reported under the earnings incidence of the new accounting regime. Further, positive features, such as emphasis in asset liability matching, may no longer be a feature of the new accounting basis.

Regulator perspective: Both action and inaction are risks. Had Canada not made this change, it would have been the sole worldwide user of its proprietary method and remained out of sync with the global community. But by embracing the new IFRS, it loses some valuable components that existed previously and may contend with a method not yet fully defined. The upside is that it does become in sync with the global community.

6.16 Permitted Practices

Instance: Permitted practices are accounting variances granted by a state's insurance department. They generally apply to companies domiciled in that state. For example, in 2009, several states allowed the quantification of deferred tax assets to be revised, resulting in more surplus being on the balance sheet of its domestic insurers.

Insurer perspective: For insurers from states without such a permitted practice, they most likely operate at a competitive disadvantage on an unlevel playing field due the conflicting requirements of their state of domicile.

Regulator perspective: Permitted practices can be a valuable tool in helping a company work through a difficult situation where the passage of time and certain actions may steer it clear from financial impairment, thus precluding the immediate exercise of takeover by the state. Permitted practices can also allow the exercise of discernment where unique events are encountered, not anticipated in prior accounting or capital guidance.

6.17 Bailouts

Instance: In the U.S., the National Organization of Life and Health Insurance Guarantee Association oversees the dissolution of insolvent companies. If the company has inadequate funds, the regulator will assess other insurers in the state based on their past premium volumes.

Insurer perspective: Why should we support the foolish moves of poorly-managed companies? Such bailouts encourage moral hazard.

Regulator perspective: This system informally "enlists" the companies in helping regulators ferret out "bad" or risky companies as they are aware that they are on the risk for the failure of their competitors.

6.18 Setting Capital Requirements (and Permitted Dividends) for an Uncertain Future

Instances: Current balance measurement options for estimating the future have a choice of two kinds of averages to use for calibrating balance sheets. One is to use an average (and implied distributions around that average) based on some past period of observable history. The other is to use the average (and implied distributions) based on today's observable market information. Depending on the time horizon and liquidity needs of the business, one of these may be more useful as a basis for setting balance sheet requirements, but certainly not sufficient, nor fully applicable to (or predictive of) the actual future periods. Minimum capital requirements will then need to be updated at some interval(s) after products have been priced and sold.

In addition, insurance contracts and regulation include references to certain published indices. The London Interbank Offered Rate (LIBOR) is an interest rate that insurers refer to and rely on to conduct business. Around 2011, it was discovered that the rate itself had been manipulated by its providers and assemblers. The valuation interest rate for life insurance and annuities was based on the Lehman Aggregate Bond index, which was no longer available after 2008.

Additional examples include:

a) In 2013, U.S. refined risk-based capital (RBC) charges for mortgage-based investments are being considered.
b) Related to a), an explicit catastrophe charge for P&C insurers is being considered.

c) On April 24, 2013, federal legislation (the Terminating Bailouts for Taxpayer Fairness Act) was introduced that would require U.S. financial institutions regulated by the Federal Reserve with more than $500 billion in assets to substantially increase their capital. The target capital is 15 percent of total assets.

d) The procyclicality of using market-based balance sheets for business with a longer duration (and without significant liquidity exposure) meant that insurers (or regulators) measuring their balance sheets in 2007 on a market value basis would have been under considerable pressure to release dividends to shareholders and policyholders. Yet in 2008, those same companies would have been even more hard pressed to raise the needed capital that they had just distributed. While updating RBC requirements can be construed as changing the rules during the middle of the game, it is also an intrinsic part of both market- and historical-based balance sheets.

Insurer perspective: For the indices, insurers are forced to operate during this time of uncertainty until suitable replacements and regulations are developed or modified. For changes to capital midstream, this introduces additional uncertainty into the company capital planning process.

Regulator perspective: Regulators need to supervise with a current environment perspective. While regulation needs to have policies and references relevant to the current real world, regulators need to ensure that such references are valid, reliable, and trustworthy.

6.19 Ability to Exit

Instance: In 2012, a global insurer's Taiwan subsidiary experienced enough adversity from a variety of sources that the parent decided to leave that market. However, the Taiwan Insurance Bureau refused to permit the exit and mandated the continuance of new business. On the other hand, in the U.S., while redomiciling is not a frequent occurrence, it is typically approved on a fairly routine basis.

Insurer perspective: For failures, we need to be able to recognize our mistakes and recover from them, not prolong them. We must be able to stem our losses. For redomiciling, in the U.S., the insurer can be domiciled in any of the states in which it is licensed. The insurer can select the jurisdiction in which the business environment is most appealing.

Regulator perspective: Companies are granted a license to serve the needs of a jurisdiction's citizens. If things do go bad, the company must still meet obligations. Should this be allowed as a corporate mitigation option? For redomiciling, in the U.S., will other states have the resources to perform the valuation and solvency reviews? Are these reviews of sufficient quality to protect residents of all states?

6.20 Competing with a Government Entity

Instance: P&C insurers selling homeowners' insurance needed to address concentration risk, particularly in a hurricane-prone area such as Florida. As a result, insurers cut back on their exposure or discontinued operations in that state. Florida countered by establishing the Citizens Property Insurance Corporation, a not-for-profit, tax-exempt government corporation whose public purpose is to provide insurance protection to Florida property owners throughout the state. This is a structural change to move insurance from a private, market function to a government-sponsored safety net. As another example, Japan's postal service offers life insurance to the public.

Insurer perspective: Are we, in effect, competing with the agency that is supervising us? Will the regulators be able to supervise even-handedly? Could the state have encouraged more insurers to enter rather than establish its own company to compete with us?

Regulator perspective: We need to be responsive stewards of the public trust. We must provide an insurance safety net for Floridians and protect Florida's economic health.

6.21 Sources of Funding

Instance: State insurance departments have significant budgetary constraints. Despite the industry being a significant source of revenue for states, only a fraction of amounts paid are allocated to insurance company supervision. In Georgia, insurance regulation receives only 4 percent of all premium taxes that are remitted to the state. In New York, the insurance department operates on 7 percent of premium taxes. In Florida, this figure is 3 percent. The industry pays $16 billion in premium taxes. If only 5 percent finds its way to regulate the industry that supplies these revenues, then nearly $15 billion has been diverted to other purposes.

Insurer perspective: Insurers are not getting a sufficient return on their investment. Consequently, the industry would object to any further assessment for additional regulation.

Regulator perspective: These taxes are a source of funds that do not show up in the general tax revenues, and are thus very attractive to use for other purposes than insurance regulation. While those in the insurance department can attempt to secure as much as they can to fund their work, the department may not be able to hire the amount and quality of the employees it needs. This issue becomes important as we look at mitigation options being considered so that regulation can be more preventative of failures as opposed to traditionally looking just to find and punish non-compliant behavior. If the legislature is not willing to commit funds for what it wants to accomplish or exerts popular political pressure, this can lead to an inability to execute already-enacted requirements due to lack of funds and/or lack of skilled and effective individuals in the department.

6.22 Underutilized Market – How to Encourage Broader Participation

Instance: Private insurance has not succeeded broadly in providing the benefits of access to lifetime income, long-term care and, in the U.S. until, arguably, now, health insurance.

Insurer perspective: The current market has been unsuccessful in creating products that have widespread appeal to their target populations. Many would argue it may be caused by current regulatory incentives such as the creation and tax subsidization of 401(k)-type defined contribution plans.

Regulator perspective: The federal government has been actively seeking input on how to more effectively build the lifetime income market.

6.23 Setting Stress-Testing Criteria

Instance: In the early part of the second decade of this century, European regulators specified that for stress test purposes, banks could expect that countries would not default on their obligations. This caused assessments to be overly optimistic. The Cypriot banks that failed in 2013, primarily due to losses in Greek government debt, had passed their European-wide stress tests in both 2010 and 2011.

Insurer/bank perspective: Many companies would argue (and believe) that they are in the best position to understand and test the stresses to which they are subject. Since they have a fiduciary

responsibility to their shareholders, their incentive is to ensure via stress testing that they can manage the risks to their shareholders (who likely have even less tolerance for risk than do the policyholders). Expecting the regulator to know and understand your risks better than you do is a dangerous way to manage on behalf of your shareholders.

Regulator perspective: Here the concern is not with most companies but with the few (or one) who may end up damaging the market in pursuit of short-term gains. Mandating a common stress test (especially for low-frequency, high-severity kinds of risks) allows regulators to see how the market participants as a whole would be impacted by this kind of event.

6.24 Striking the Balance between Simplicity and Accuracy

Instance: Solvency adequacy approaches generally take one of two forms. A standard formula approach is one-size-fits-all and cannot reflect unique risks to each company. The standard formula may have been more reliable and predictive when introduced in the U.S. in the 1980s, but with diversification, globalization, and increase in speed of transaction, the standard formula is challenged to reflect all the elements of deterioration that a regulator needs to know.

Alternatively, an approach using internal models is difficult to audit and subject to judgment in formulas, relationships, and assumptions. In 2012, the investment bank J P Morgan didn't like its internal model results and made drastic changes to it. A few quarters later, it was apparent the original model's parameters were correct as the firm needed to raise capital.

Insurer perspective and regulator perspective: Both would likely concur that each approach's strength can be a weakness. It is possible that both approaches would be needed.

6.25 Dual Role as Regulator/Supervisor

Instance: Canada has a consolidated regulatory function in OSFI while the U.S. has a very diverse and fragmented one. Each has strengths and weaknesses.

Insurer perspective: Desired size of government oversight often correlates with size of insurer. Smaller companies will find it more difficult to invest in the talent and experience needed to represent their points of view to the legislature and the regulator at a national level. Both large and small companies, though, will typically have good working relationships with their appropriate local regulators, who will appreciate and understand their market and value to their state community. While state governments can be slow to act and can take many years to gain consensus on important topics, they are also less likely to mandate a requirement without understanding its consequences on the market.

Regulator perspective: State regulators point out that built into their system of reliance on other states is the right and expectation to challenge the lead state to ensure that local favoritism is not occurring. One factor in OSFI's success is that all of the large banks and insurers have a home office in Toronto so OSFI has the ability to easily set up and have personal one-on-one conversations.

6.26 Cross-Border or Cross-Jurisdictional Issues Where Other Regulators have Different Missions and/or Priorities

Instance: For some regulators, their greatest focus may be that of controlling risk via verifying compliance of a set of requirements. Another may focus on building/enhancing risk measurement and risk management tools at its disposal, and still another on actively steering risk, as is the case for regulators concerned about macro or systemic risks. Consider in the U.S. the impact of different

missions and priorities for 51 state insurance departments and legislators, the state attorney general role, the courts (state and Federal), FINRA, the SEC, the PCAOB, the Consumer Protection Board, and the FIO. Even within one regulatory body there may be staff to fulfill all three of these functions and they will still face the "competing silos" issue faced by all organizations with more than one function.

Insurer perspective: As the world has increased in global interactions and products have become more complex, the need to accept/appreciate the need for collaborative regulation has also grown. The initial concern is to maintain the company's data privacy to safeguard pricing or other information (such as customer privacy). The second concern is to not have conflicting regulations in separate jurisdictions.

Regulator perspective: Requires extra resources and collaboration to be part of a supervisory college, but the joint discussions will also allow training and faster development of regulatory supervision "best practices".

6.27 Interpretive Differences of Complex Regulations Causing Unlevel Playing Fields

Instance: In 2013, New York's financial regulator threatened to upend a pending acquisition by imposing new rules that had not previously applied to traditional insurers. These conditions were imposed based on New York's view of the acquiring firm's prior practices.

Insurer perspective: We have complied with all existing laws and regulations. Furthermore, we have had success even if it means we will increase competitive pressure on other carriers and increase regulatory concern about greater solvency risks. Generally speaking, we have just been more innovative in seeing business opportunities in the market.

Regulator perspective: It is our responsibility to protect policyholders and we do not need to wait if we see a crisis coming.

6.28 Detroit Default

Instance: In July of 2013, the city of Detroit filed a petition for bankruptcy and later the courts approved the city's eligibility for debt restructuring. This recognized the inability of the city to pay its debts, from payroll and supplies to unfunded pensions and municipal bonds. A judge ruled that the bankruptcy violated the state constitution and ordered the city to withdraw its bankruptcy petition.

The municipal nature of the obligations makes it difficult to say which creditors will lose and which will win. Holders of revenue bonds, such as those backed by sewer or water facilities, are more likely to be paid in full than general obligation (GO) bonds. Detroit's city manager wanted to treat the GO bonds (which are secured by property taxes) as if they were the same as unsecured debt. The GO payments are guaranteed by the Michigan constitution.

The city's major long-term liabilities are city pensions and retiree health care. The city manager was quoted as saying, "We cannot pay it. Everyone has known that for 20 years, and no one has wanted to deal with it." (*Wall Street Journal,* 20 July 2013.)

Insurer perspective: Should Detroit GO bonds default, insurers will likely demand higher returns on future issues to compensate for the higher perceived risk. The share value of bond insurance companies has diminished. Life insurers, while having their municipal assets stressed, may see opportunity in providing current or future municipal or state pensioners with retirement security products.

Regulator perspective: There is overlapping jurisdiction in these areas. Federal bankruptcy law allows judges to cut benefits to pension holders. This contradicts Michigan's constitution, which states that retirement benefits of the state and its governmental subdivisions shall not be diminished.

6.29 Social Security Symmetry

Instance: For many years, insurers have been using publicly-available death records from the U.S. Social Security program to identify deceased payees and remove them from the inventory of annuity and long-term care claimants.

Insurer perspective: This needs to be done to avoid over-paying consumers and to protect solvency.

Regulator perspective: Regulators concurred with this practice and felt it was beneficial to expand it to life insurance, especially for blocks of paid-up business. While insurers were generally willing to expand their use of the Social Security Death Master File, they were reluctant to pay fines for conduct that was not illegal.

6.30 A Foot on Each Side of the Ocean

Instance: Regulatory regimes have developed different solvency measures and philosophies in North America and Europe. For example, the U.S. has chosen to focus on a much more involved supervisory oversight and review process than is used in the EU, which makes it more comfortable with the perceived lower level of conservatism in U.S. insurer's balance sheets.

Insurer perspective: Insurers in several jurisdictions may well need to be capitalized at the larger level in order to maintain good solvency marks. Thus, for example, some European-owned North American insurers may be at a competitive disadvantage to their domestic peers when it comes to price for the policyholder and return to the shareholder.

Regulator perspective: Regulators from North America and around the world understand there are issues and are working together to come to a global understanding of what is an appropriate solvency regulation. But, at the end of the day, regulators are responsible to policyholders in their own jurisdictions and regulate the way they view is appropriate.

6.31 Legislation in Limbo

Instance: Legislatures sometimes need more than a single session to develop and pass new legislation. When a new or revised law is being developed, a great degree of uncertainty is introduced up until the time that the legislation is passed. An example of this is a revision of the insurance tax code. The tax authorities proposed new regulation for the taxation of insurance companies in 1983. This legislation contained major revisions to the tax code. Consequently, new product development, new reinsurance treaties, sales of blocks of business, and mergers/acquisitions ground to a halt. This is also true for the development of new accounting regimes, as when future reporting paradigms are in development, insurers will not know the emergence of earnings or required reserve levels.

Insurer perspective: Some of the talent employed by insurers and their suppliers found their skills not in demand. Employers had to lay off or find other work until tax legislation passed and demand for such skills rebounded.

Regulator perspective: Not all legislation can be completed in a single cycle, given its complexity or its political nature.

6.32 Managing Major Regulatory Change

Instance: Section 3.1.6 described Mexico's current plans to implement a more modernized risk-focused reporting process. We will use this situation to provide a more extensive list of implications of the risks involved from both an insurer and regulator perspective

Insurer perspectives: While the overall direction is supported, there are important practical implementation questions that still need to be addressed and resolved:

1. Will interest rate curve shocks affect the whole curve or just a single interest rate point on the curve?
2. How will the regulator allocate its resources to oversee both the numbers and the governance/risk culture of the company? The law is quite mathematical in its language. Some argue it lacks enough legal content and implies the focus is on form (numbers and process), not substantive governance issues, even though the CNSF is clear it is focusing on both numbers and on governance/risk culture.
3. How will some important reinsurance issues be addressed? These include:
    a. Can long-term reinsurance be treated as an asset?
    b. Can non-proportional reinsurance be recognized as a long-term risk transfer event instead of as a service?
    c. What is the guidance or framework to be used to determine if reinsurance is being used for risk transfer (and reduction of risk) or being used for regulatory arbitrage?
4. Will small companies face major costs to implement all of the technical requirements?
5. Without a validation process for the regulatory model, the model and current regulations will create distortions in the reinsurance market for catastrophe insurance. For a further explanation of this topic, see a paper presented by Luis Alvarez, Maria do los Angeles Yanez, and Miguel Angel do la Garza Camacho at the ASTIN/AFIR/IAALS Colloquia, October 2012, at: http://bit.ly/AlvarezAngeles.

Regulator perspectives (many of which may also be shared by the companies):

1. What is the impact of the proposed changes on the market in Mexico? This includes how to interpret (and package) the results so they are more transparent to investors, the public, and the banking regulatory community. For example, GE closed its very profitable Mexican operation because it did not want to translate its insurance metrics to those used by its other businesses. Does a change in reported equity under the new regime change leverage and book-to-equity ratios used by outside analysts?
2. Is the timeline sufficient to develop and specify the parameters needed to calculate required capital (and reserves)? Even more importantly, is the timeline sufficient for defining and submitting the data requested by the regulator to input into the regulator's internal industry model(s)?
3. Will a regulator-specified model (and parameters) create misalignments between the actual risk exposures and the reported risk exposures?
4. How to handle the balance of requiring too much detail (needed for comparability) yet also maintain the flexibility to address/include new product designs, risks, and markets?

5. Will regulation clarify governance or just be more paperwork (for both regulators and companies)? Does it clarify who is accountable to know the insurance business?
6. Will it be able to discern and motivate good (and better) governance/sound management, which is the core objective of the process?

SECTION 7. STRATEGIES TO ADDRESS REGULATORY RISK

This section identifies strategies that regulators and insurers can use to address regulatory risk. As defined in section 1, regulatory risk comprises the potential and actual challenges faced by insurers and regulators under a supervisory regime arising from changes to products and/or regulations and the intended and unintended results of regulations that put at risk the ability of policyholders, shareholders, or regulators to achieve their legal or fiduciary objectives.

7.1 Strategies for Regulators and Insurers

Traditionally, common practice has been to respond to regulatory risk in a piecemeal and reactive fashion. Both regulators and companies are beginning to consider the macro issues and to contemplate proactive solutions. Thus, using key risk management principles to manage regulatory risk will be essential to effective execution. While many of these principles are evident in practices already being used by both parties, it is helpful to see them as part of a disciplined process used to manage risk. In the same way that a double-entry accounting system has a coherent set of principles to address the risk of cash "disappearing", so does a defined ERM process enhance the ability for risk to not "disappear" and thus be consciously managed.

While each institutional ERM process has its own unique adaptations and nomenclature, there are important commonalities. One way of describing an ERM process (and the one used here) includes a) the identification of risk, b) the evaluation of risk, c) the treatment of risk, and d) the assessment of the residual and emerging risks.

Another common set of terms to define this cycle could be *identify, measure, mitigate,* and *evaluate*. The key common feature is the idea of a cycle that ends with a feedback loop that inputs into a re-start of the cycle. Recently the ASB of the U.S. issued two standards for actuaries working in an ERM context. One focused on the treatment of risk and the other on the evaluation of risk. There they described the ERM control cycle as "the continuing process by which risks are identified, risks are evaluated, risk appetites are chosen, risk limits are set, risks are accepted or avoided, risk mitigation activities are performed, and actions are taken when risk limits are breached."

Lastly, it needs to be recognized that the actuarial profession has played a unique strategic role for both regulators and industry due to the reliance placed on actuaries to model and communicate the risk exposures to both parties. Thus, there are actuarial standards relating to cash-flow testing, policy illustrations, repricing and dividend calculations, and actuarial opinions to sharpen and enhance the control function of the actuary in the process. It is this professional role and awareness of risk that has led the profession to focus on the larger issue of managing risk through a structured ERM process.

7.1.1 The Identification of Risk

Regulators have certain mandates and priorities, which, as seen in the sections on the three North American environments, will be uniquely tailored to the legal and political realities of each country. However, each jurisdiction contains requirements that may include authorizing, enforcing, monitoring, rescuing and/or preventing company failures, and fostering product innovation in the market place. What risks could prevent them from achieving these objectives?

OSFI's use of a quarterly risk survey is a good example of how to manage this part of the cycle. It includes diverse items like identifying operational risks (such as sufficiently capable staff or political issues), financial risks and business cycles which will impact the companies they regulate

at a macro level, emerging product trends, micro issues specific to an individual company, and the unintended consequences of proposed regulations.

From an industry viewpoint, regulatory risk has emerged as a major identified risk. PricewaterhouseCooper's 17th annual Global Survey indicated on page 5 that "Many CEOs also remain very nervous about government efforts to balance reform with growth. Over-regulation tops the list of potential threats to their organizations' growth prospects, with 72 percent expressing concern about this. And the ability of debt-laden governments to tackle soaring deficits has been one of the biggest clouds on CEOs' horizons for the past four years, with 71 percent worrying about this, compared to 61 percent in 2011. In addition, 88 percent of CEOs in North America are concerned about government response to fiscal deficit and debt burden, compared to71 percent globally."

7.1.2 The Evaluation of Risk

Once identified, there needs to be an assessment of which risks need to be treated (this can include a definition of how to quantify/prioritize competing risks) and how to evaluate the needed resources, whether financial, legal, or logistical. This includes evaluating whether the risks are tied to resources, processes, or priorities so that an appropriate mitigation can be applied. For insurers, *resources* typically refers to capital, while for regulators it refers to staffing. Processes for an industry may be seen and/or mitigated via the ORSA and ERM functions while process risks for regulators may need legislative authority to address. Priorities are usually described as strategic risks.

7.1.3 The Treatment (or Mitigation) of Risk

For regulators, these treatment options may vary from new laws, new staffing needs, and an increased focus on fines to investigations or public hearings on whether and how to permit a new product in the market. Risk may also lead to new monitoring tools, early warning indicators or public saber rattling, and/or education. Accreditation standards and/or equivalency assessments can also be used to reduce the risk of regulatory arbitrage. While this task is fairly well understood in a corporate environment, examples of risk evaluation linked to the chosen treatment in a regulatory environment include:

- The CNSF in Mexico identified there was an increasing sophistication of insurance and a perception that companies may be lacking the forward-looking tools to ensure sustainable operations in this changing environment. This led to the recommendation for the new regulatory reporting, governance, and capital requirements over roughly the last decade or so.
- A November 11, 2013, article in the *New Yorker* magazine discussed the actions and priorities of the new chair of the SEC. These actions demonstrate the assessment that there had been a prior lack of enforcement of existing regulations and the most urgent regulatory priority should be the vigorous enforcement of current laws (and hence to invest very little resources into finalizing the regulatory detailed requirements to implement Dodd-Frank).
- The states (and then the NAIC) in the U.S. have recognized that the historical static, formulaic life reserve requirements they have developed can miss emerging risks. They have developed several tools to address this issue over the last decade or more. These include:

- Organization of a group of state analysts to review and use ratios and emerging trend indicators via the Financial Analysis Working Group (FAWG);
- Development of a model law for an ORSA;
- Development of the principles-based reserves model law; and
- Evaluation of new product trends to see if they may or may not be a problem in the market place.

7.1.4 The Assessment of Risk

This aspect naturally overlaps with and leads to a new cycle of identification, evaluation, and treatment. The treatment of a risk will always be left with either some residual risk (which may change its key drivers in reaction to a decided course of action for its treatment) or introduce some new risk. In addition, this step can be most effective when combined with an interactive review that includes both the regulatory and industry feedback on the "gaps" or second-order consequences. Some examples include:

- Mexico has been doing a series of impact studies prior to the implementation of its Solvency Dos requirements in order to identify what may be missing or needs to be improved on and includes feedback from the industry. At the same time, the gap in the assessment is that impact studies can only capture an understanding at a past point in time. They are not able to assess how possible future environments may impact the proposed requirements unless this gap is felt significant enough to address through other means.
- OSFI includes as part of its review of regulations an exploration of what the second- and third-order consequences might be of the proposed regulation(s) on the soundness of the market. It also holds an annual discussion with the heads of its regulated companies to discuss the major risks that OSFI has decided to focus on, and gets input on their proposed plans.
- The NAIC and the AAA have spent the last few years on collaborative projects to review and improve the more model/principle-based reserve and capital reporting requirements that are already in place.

7.2 Strategies for Insurers

The regulatory risk function may be considered either an operational or strategic risk. The execution of regulatory risk mitigation will reflect the culture of the entity. The regulatory risk mitigation efforts may reside in one or more of several areas of an insurer.

7.2.1 Compliance

The compliance function is generally an operational tactic used to assure that performance adheres and conforms to existing laws and regulations as well as company-established procedures. A distinct compliance department may be housed in the legal area. Compliance work may be done within business units, such as a compliance area within policy form development, generally a unit within the pricing function.

7.2.2 Internal Audit

While traditionally more accounting-focused, the internal audit (IA) function could grow to include strategic evaluation, such as validating the execution of regulatory risk mitigation. Recent

growth has, sometimes, included the incorporation of the ERM function, partly because the IA function often has responsibility for communicating directly to the board of directors.

IA could evolve to focus on the issues associated with delivering sustainable value to shareholders, customers, and employees, above and beyond what they are already doing. These deliverables include financial strength and resilience, treating customers fairly, and meeting regulatory and legal obligations. Promoting effective controls, independently challenging management's assertions, and assessing the effectiveness of an insurance company's risk management function, including regulatory risk, are a growth area for IA. An example of this would be for IA to monitor the continued propriety of a company's ORSA. However, these same functions are more typically performed by the CRO/ERM responsibilities within an organization.

7.2.3 Government Relations

Companies will often designate a person to be the government relations (GR) specialist. Larger companies may have more than one person filling this role. GR is a role that entails proactive communication and active participation in the process to help inform and shape rules and regulations.

7.2.3.1 Ideal Characteristics

The person who performs the GR function will interact with many if not all of the jurisdictions and organizations cited in sections 2, 3, 4, and 5. The ideal person will have several attributes: thorough knowledge of one or more operating areas, general knowledge of all areas, articulation, organization, and eloquence. This function will be involved in frequent conference calls and industry meetings. This person must understand his/her company's practices and needs to convey issues as they emerge. In addition they need to build a credible presence with regulators and understand the regulatory objectives and constraints if they wish to provide effective proposals. This could consist of helping regulators identify and close gaps in regulation or currently existing arbitrage opportunities in order to facilitate a level playing field.

7.2.3.2 Awareness of the Political World Surrounding Regulators

The GR function must understand the environment (legal powers and public accountability) in which the regulator works. The GR function must be able to understand how the regulator can also achieve its important objectives in any endeavor. It is imperative the GR function can follow the regulator's chain of command and comprehend how decisions are made all along this chain. Having the insurer involved in activities germane to the interests of those involved in making regulatory decisions is helpful.

7.2.3.3 Identifying Opportunity and Future Risks

The GR function may contribute to identifying opportunities and risks in the following situations:

1. Where there is a potential for regulatory advantages under current supervisory regimes. For example, companies may choose to redomesticate to take advantage of differing business climates that may be affected by regulation interpretation or premium tax assessment.
2. When there is a need for a regulator to approve or deny an acquisition or reinsurance treaty to understand the key risk issues that the regulator may need to address. An insurer may want to push an envelope (for example, seeking capital relief by establishing a captive insurer) to meet shareholder expectations. To the extent there exists a multitude of regulators and a range of regulations and their interpretations, companies will have

opportunities (with their associated risks) to evaluate and choose the level of regulatory risk they wish to take on in order to balance the shareholder and/or policyholder expectations.

3. The GR function needs to be aware of market trends and innovations to identify opportunities for working with regulators to ensure a feasible future for products. This could include working to modify existing regulations or creating new regulations to fit new product concepts.
4. Identify where existing regulations are not working and foresee where proposed regulation might not work. Currently the G-20 desire for uniform international insurance regulation needs to consider how international standards can apply within countries with diverse cultural and legal differences, including jurisdictions with regulatory overlap such as when the Federal Reserve now has dual jurisdiction with the states over some insurers.

7.2.3.4 Being Active with Professional Organizations and Trade Associations

Professional organizations such as the AICPA, CIA, AAA, AMA, and IAA all influence the development of insurance regulations. To have maximum input, an insurer should regularly participate in the development of policy within these groups. Further, the representative to these groups should attend national and regional meetings.

Trade associations are significantly influential in the development of regulations. To optimize effectiveness, an insurer should participate in the development of strategies and execution of tactics for these associations.

Also, participating in organizations such as the CRO (Chief Risk Officers) Council(s) can help establish educative influence in the regulatory risk arena.

7.3 Strategies for Regulators

7.3.1 Regulators May Consider Utilizing the ERM Control Cycle Beyond its Traditional Focus on Financial Risk

This means consciously allocating resources and priorities to those areas of highest risk/reward. In an era where there are often declining dollars for regulatory initiatives while financial and risk complexity is increasing, it becomes essential to use limited resources more effectively. This includes the processes and strategies described in the following subsections.

7.3.1.1 Evaluating the Efficacy of the Regulatory Review and Approval Processes

When additional tools/resources are contemplated, are they able to replace longer-established procedures? For some states in the U.S., the use of risk-focused exams has led to quicker, less expensive, and yet more thorough reviews. Other companies have felt that their risk-focused reviews just added an additional layer of cost without any additional perceived benefit. Thus, having a way to review if and how additional regulation may or may not be more efficient is an important consideration.

7.3.1.2 Being Able to Distinguish and Prioritize Regulatory Resources

Distinguishing and prioritizing regulatory resources is important, especially for fraud, micro financial assessment of a specific firm, and the macro assessment of the industry or industry segments. Some risks can be ignored because the risk is not material for a single company, but in

aggregate it might pose a disturbing trend for the industry. Some examples of early warning indicators that have been used historically to help allocate resources include:

a. Rapid rise in premiums;
b. Rise in consumer complaints; and
c. Innovative product or legal structures with no apparent business value.

Business value may include tax savings or operational advantages. When the structure is complex with interdependent guarantees or methods that make risks seem to disappear, attention is warranted. Some firms avoided the stresses of 2008 because they could not see how the complex mortgage packages were generating value in a way that made sense.

7.3.2 Increased Collaboration and the Use of Impact Studies

The political and regulatory climate is one that is committed to no further use of tax dollars to address the impact of a business failure(s). The summer of 2014 will see field tests being done for 20 large IAIGs in an IAIS-driven project so that they will be able to understand the options for and implications of setting basic capital requirements in late 2014 and to set the groundwork for understanding possible international capital standards. Both industry and regulators will gain from being able to communicate to others outside the insurance industry if and when there might be risks to insured entities.

7.3.3 Insight from the Future ORSA Filings

Thoughtful reviews of future ORSA filings should help regulators understand which business model(s) is (are) being used by a firm, how it generates value (profits), and when that model has shifted due to changes in the market. The ORSA will be a general filing requirement in the U.S. and the EU in the next few years. Field testing comments from U.S. regulators involved in the reviews already occurring have stated that these reviews will be of significant value to regulators in their examination process.

7.4 Concluding Comments

This research has been carried out in order to provide some productive ways to understand, organize, and manage regulatory risk. While this issue impacts both regulators and industry in different ways (that will also vary by legal jurisdiction), the authors hope the suggested strategies are seen as starting points for more productive and effective management of regulatory risk. Insurance in the prior decade was already moving toward greater transparency of risk in a prospective manner. The watershed events of 2008 have only accelerated this need for a culture change. And this culture change is evident even in such subtle ways as the Ohio Insurance Department renaming its examination team to be the "risk assessment division". Beyond regulating compliance of laws and financial reporting requirements, how will regulators and companies manage the risk of their future interactive behaviors? This includes taking into account future economic and insurance risks as well as the legal and political implications that may accompany those events. The authors look forward to seeing how this risk management practice evolves at both a micro and macro level as it assesses how current capital, behaviors, and processes are equipped to deal with future stresses in a sustainable fashion.