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Regulatory Risk in North America: A Practitioner's Perspective



Study Sponsors and Authors



- Initiated by the North American Actuarial Collaborative Research Group and funded by a partnership of the CAS/CIA/SOA
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List of Sources



- Interviews with Industry & Regulatory Colleagues. Key additional bodies included:
 - OSFI - Canada
 - CNSF – Mexico
 - NAIC & State Regulators – United States



Paper Outline



1. Introduction
2. Insurance Regulation in the United States
3. Insurance Regulation in Mexico
4. Insurance Regulation in Canada
5. Other Organizations, National & Intl., with Significant Influence on Insurers
6. Regulatory Risk Examples
7. Strategies to Address Regulatory Risk



Presentation Outline



- Purpose of Paper & Definition of Risk
- Regulatory Functions & Structures
- Examples
- Mitigation Options



Audience for Paper



- a) an actuary who must price policies, value policies, or manage capital
- b) other insurance professionals who deal with operational risk, strategic risk and capital planning
- c) regulators who protect the interest of policyholders and address the solvency of insurers.



Purpose of Paper



- Provide a structured way to think about identifying and mitigating regulatory risk
- Contribute an actuarial perspective to managing risks that can be identified, but are not easily quantifiable (To challenge Peter Drucker - How to manage that which can't be quantified)

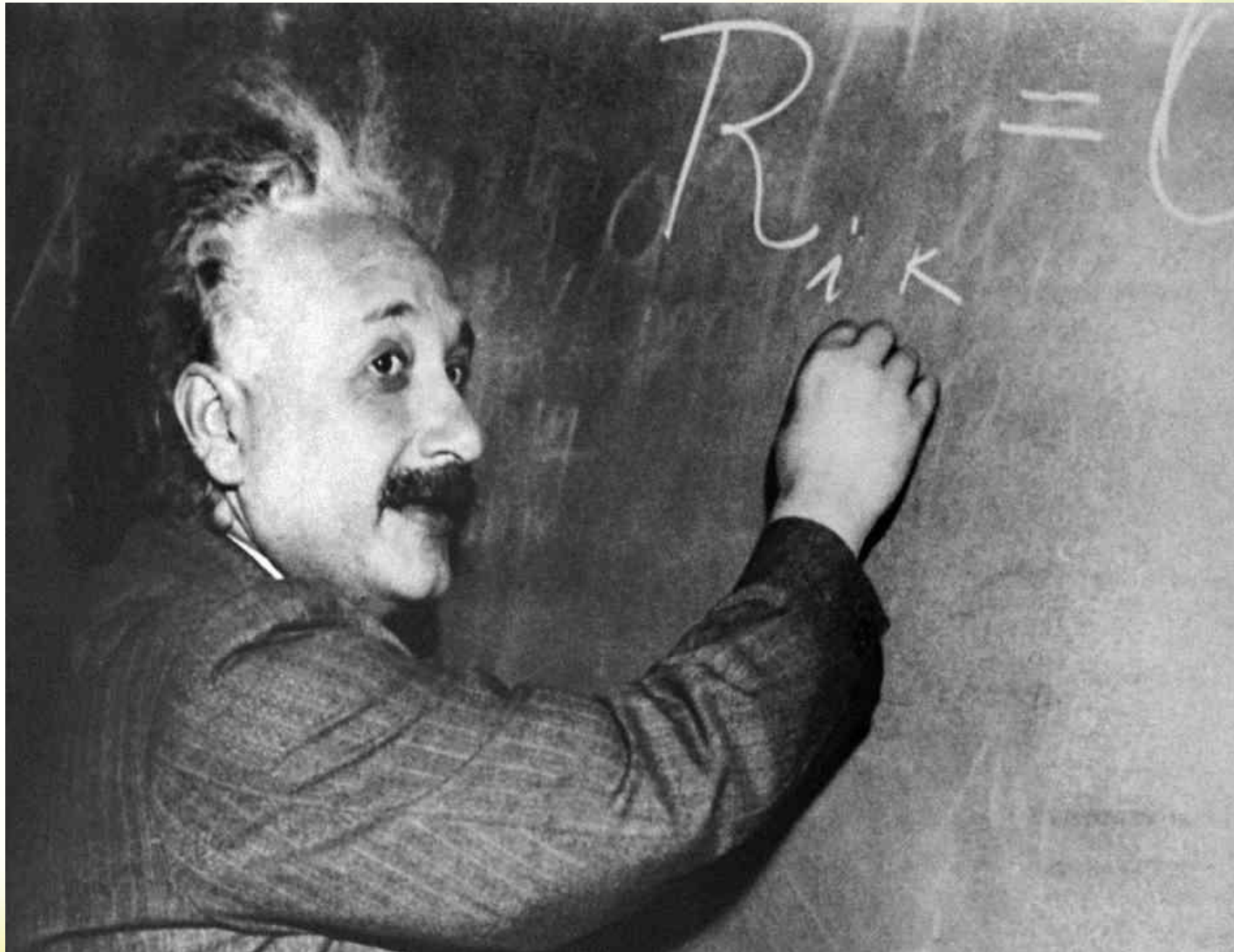


Risk is Major Concern of CEO's by a wide margin over other risks



- 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% expressing concern about this...In addition, *88% of CEOs in North America are concerned about government response to fiscal deficit and debt burden, compared to 71% globally.*"





Working Definition of Regulatory Risk



- 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.



Customary Risk = Opportunity Map



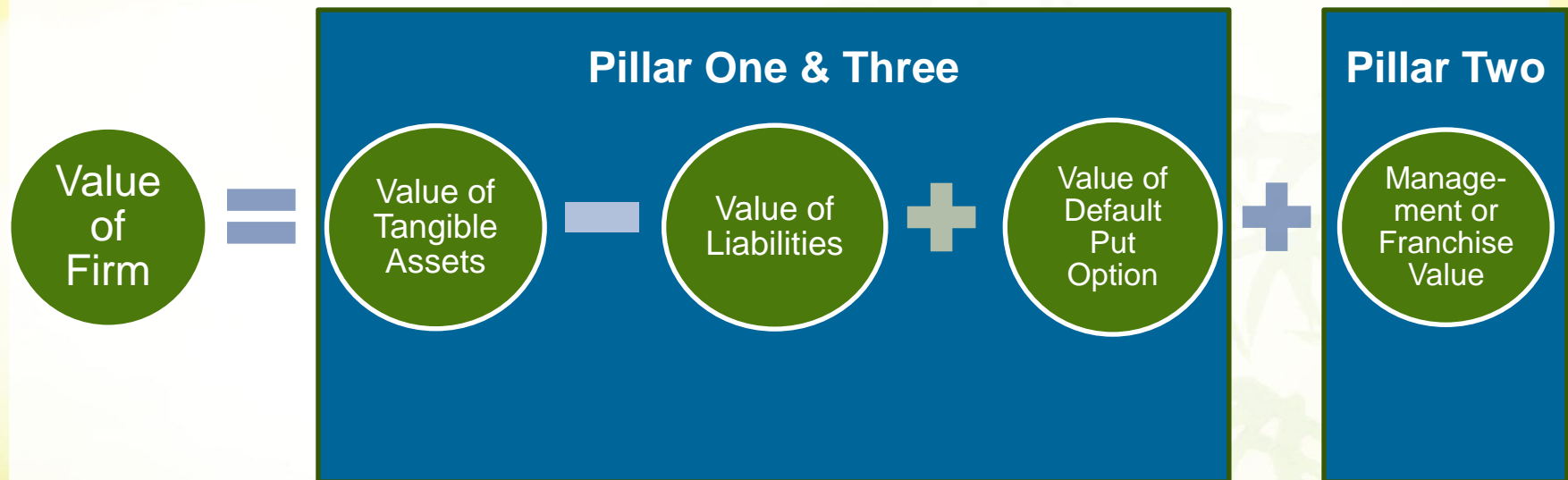
Additional Risk Management Issue



What is the Traditional Value Equation?

Value of Put Option –

(Babbel / Merrill Journal of Risk & Insurance 2005)



Three Ways to Address Risk

- Resources
- Processes
- Priorities

*Shout out to Clayton Christiansen and “How Will You Measure Your Life?”

Traditional Regulatory Functions (Priorities)



- Granting Permissions to Operate
 - Company Licenses
 - Agent Licenses
 - Product Approvals
- Enacting laws (legislative driven) & regulations (supervisor driven)
 - Market Conduct
 - Financial Reporting & Minimum Reserves/Capital



Emerging Regulatory Priorities



- Mandate/Expectation for Regulator to not just “Issue traffic tickets”, but to also prevent traffic jams.
- Law makers delegating more to regulators to set (and understand the impact of) rules that shape behaviors in the market place.
 - FIO Mandate = identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the US financial system. FSOC is to then ensure no tax dollars are used to address losses



Regulatory Structure Options



- Mandates – Relative Balancing of Solvency vs. Cheaper Products (Priority)
- Centralized vs. Decentralized (Process)
- Degree of Integration with other Financial Regulators/Supervisors (Process/Priority)



Mandates (Risk Appetite/Priority Statements)



- Mexico – An orderly market, meaning sustained solvency is their only mandate
- US – An orderly & competitive market. Most states include this dual mandate
- OSFI – An orderly market while “considering” the impact their regulations have on the market.
- Example – relative prevalence of VA type of guarantees



Central vs. Decentralized



- Mexico - Centralized (but Insurance is co-member with all financial supervisors) - States can only mandate to have auto insurance, not its price or features. Minimal focus on market conduct
- Canada - Centralized (banking and insurance together) – Political compromise gives province of Quebec authority for Quebec only companies



Sample States



State	CA	IL	MN	NE	NY
Population 38	13	5	4	19 (millions)	
Commissioner	E	A	A	A	A (Elected or Appointed)
Licensed insurers	1.8	6.6	1.2	1.4	1,4 (thousands)
Domiciled insurers	235	314	160	65	400
Employees 1,300	260	90	100	800	
Actuaries	25	12	5	4	65
Annual budget		45	15	15	145 (\$ millions)

In US, insurance department budgets are about 5% of premium tax collected.

Industry pays \$16 B in PT; thus \$15 B has been diverted from regulatory resources



Sample Countries



Canada – OFSI (Office of the Superintendent of Financial Institutions) oversees financial stability at federal level; consumer issues supervised at provincial level

OFSI has 660 employees; HQ in Toronto, close to most regulatees

Research, emerging risks, feedback

Taiwan – 23 million people, 50 insurers

Insurance Bureau – 100 employees

Overseeing Commissioner(s), when term completed, may not take a job in any industry they regulated

Taiwan Institute for Insurance – equally sized research organization, 100% funded by industry but steered by IB

Operations manual & fines

An agency completely independent of financial services oversees all consumer issues



Resources & Priorities - Canada

- 15% of staff is infrastructure (IT, HR, etc)
- 50%+ are focused on Supervision (Exams, etc.)
- Rest are Prospective Focused
 - Future Capital Requirements
 - Assess unintended consequences
 - Review new product issues
 - Emerging Risks to OSFI

Canada (cont.)

- Risk Assessment shared publicly in an Annual Report
- Feedback Loop from those Regulated
 - Via an annual independent survey to assess how well OSFI is meeting its objectives from the viewpoint of those being regulated

US - Land of Regulatory Opportunity



- Company may have
 - 50+ State Insurance Dept. Jurisdictions
 - 50+ State Attorney General Jurisdictions
 - SEC
 - FASB accounting requirements
 - FINRA Broker Dealer requirements
 - Class actions via State & Federal Courts





Also in the US

- **NAIC** trade association for states; KC, NYC, Washington DC; 425 employees
- **NCOIL** trade association for state regulators
- **FIO** created by D-F; looks for gaps; systemic; international
- **FSOC** also created by D-F; systemic risk
- **Fed** looks at non-bank SIFI's
- **DOL** work environment
- **CFPB** also created by D-F; consumer financial protection
- **PCAOB** (Public Company Accounting Oversight Board)



Other Organizations 2 of 5



- Accounting Firms
- PCAOB (Public Company Accounting Oversight Board)
- ASB (Actuarial Standards Board)
- ABCD (Actuarial Board for Counseling and Discipline)
- Actuarial public policy organizations
 - American Academy of Actuaries (AAA) 17,000 members
 - Canadian Institute of Actuaries (CIA) 4,000 members
 - Asociacion Mexican de Actuarios (AMA) 300 members
 - National College of Actuaries (CONAC)
 - International Association of Actuaries (IAA) 90 members



Other Organizations 3 of 5



- Trade Organizations – ACLI, PCI, NAMIC, AIA, RAA
- IMF (International Monetary Fund)
 - Sponsor of FSAP (Financial Sector Assessment Program)
 - FSAP certifies acceptability of insurance regulation
- World Bank
 - Makes loans to countries
 - Offers technical assistance to regulators in developing countries
- OECD (Office of Economic Cooperation and Development)
 - Promotes policies to improve well-being of people
 - Sets international standards ...from agriculture to tax to safety of chemicals



Other Organizations 4 of 5



- Joint Forum – bank, insurance and security regulators
- Geneva Association – think tank / research body for insurer CEO's
- FSB (Financial Stability Board)
 - Created by G-20
 - Develops and implements effective financial regulation



Other Organizations 5 of 5



- EIOPA (European Insurance and Occupational Pensions Authority)
 - Comprises regulators; based in Frankfurt
 - Primary drivers of S2
- European Commission – enacts EU policies
- OFAC (Office of Foreign Assets Control)
 - Prohibited transactions, economic sanctions
- FINRA (Financial Industry Regulatory Authority)
 - Regulates securities firms
 - Investor protection, market integrity



Examples of Regulatory Risk



- 6.3 Too Many Regulators
 - In US, state, federal and international
 - Conflicts between and within
 - Can lead to unlevel playing field
 - From Paul Volker: “the US does not need six financial regulatory agencies. It is a recipe for indecision, neglect and stalemate, adding up to ineffectiveness.”

Examples of Regulatory Risk

- 6.8 & 6.9 Variations in regulatory requirements
 - Valuation
 - Laws, and effective dates, vary by state
 - Different effectiveness of actuarial guidelines
 - Product Approval
 - Provisions – example gender-specific vs unisex
 - Rate increases – Long Term Care
 - P&C rate filing – prior approval vs. file and use
 - In Europe, gender-specific rates outlawed



Examples of Regulatory Risk



- 6.15 Change in Accounting Basis

- Examples

- Canada – CALM vs. SII vs. IFRS
 - US 1984 tax law delay
 - US general purpose – targeted US GAAP enhancements or IFRS

- Consequences

- Expensive to convert
 - Years to understand, embrace and manage
 - Prior basis future earnings may never be reported
 - Earnings already reported may be reported again

Examples of Regulatory Risk



- 6.19 Inability to Exit
 - In US, a company can suspend line of business
 - In US, a company can redomicile
 - Taiwan example
 - Multi-nationals enter
 - Conditions go south
 - IB refuses to allow them to leave and mandates continuation of new business

Unclear or Multiple Regulatory Oversight

- Cross Border with Differing Agenda's
- Within One Country – Multiple oversight
- For Complex Regulations there will not be uniform interpretations (regulator or regulated)

Format & Structure of Regulations



- Use of Rules vs. Principles
- Technical Standards (Capital - [simplicity vs. accuracy], Loss Ratios, Risk Pooling, Procyclical)
- Who pays for failure?
- Can govt retroactively change prior laws?



Observations on Examples



- Both regulators and industry were divided fairly evenly between pros and cons of too much or too little regulation.
- Shareholders and policyholders/claimants each can be at risk from regulations that are too general or are too specific.



Observations



1. Sometimes Industry wants more regulations
2. Sometimes regulators want less rules
3. Regulator must protect future and/or current policyholders, but which takes precedence?
4. Rules impact behavior in the market. Do 2nd order impacts of changes undermine or increase the soundness of the market?



Mitigation Strategies (Process) Whether Industry or Regulator

Use disciplined process to

- Identify Risk
- Evaluate/Analyze Risk
- Treat (or Mitigate) Risk
- Assess Residual Risk to Identify Start of new Cycle

Strategies for Insurers

- Compliance & Internal Audit
- Government Relations & Actuarial function
(Self Interest vs. Thought Leadership & Collaboration)
 - Idea characteristics
 - Awareness of political world surrounding regulators
 - Identifying opportunity
 - Avoiding problems
 - Active with professional organizations and trade associations

Strategies for Regulators

- Use ERM control cycle (and culture) beyond its traditional focus, including ORSA
- Prioritize resources
- Increased collaboration

Organizations Represented



The organizations represented on the group include:

- Actuarial Foundation
- American Academy of Actuaries
- ASPAA College of Pension Actuaries
- Association of Mexican Actuaries
- Association of Mexican Consulting Actuaries
- Canadian Institute of Actuaries
- Casualty Actuarial Society
- Colegio Nacional de Actuarios of Mexico
- Conference of Consulting Actuaries
- Society of Actuaries



NAAC CRG Mission Statement



“The NAAC Collaborative Research Group is composed of representatives from the NAAC organizations who are knowledgeable about the research conducted by the organizations. The Group’s mission is to:

- (a) share information about each organization’s research priorities and initiatives;*
- (b) promote collaboration;*
- (c) minimize duplication;*
- (d) brainstorm on topics for potential partnered research by the organizations;*
- (e) identify research projects with a potential for public policy advocacy; and*
- (f) coordinate funding as needed.*

In pursuing its mission, the Group may reach out to non-actuarial organizations, academic institutions, and other experts for input as to worthy research to initiate. The Group will also consider how to best publicize and distribute to a wide audience any applicable partnered research.”





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