



International Association for the Study of Insurance Economics

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Ms Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW
US- Washington, DC 20551

12 CFR Part 252, Regulation YY:
Docket No. 1438, RIN 7100-AD.86

30 April 2012

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Ladies and Gentlemen,

The Geneva Association appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System (Board) proposed rules that would implement the enhanced prudential standards required to be established under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) and the early remediation requirements established under Section 166 of the Act. The proposed rules are intended to provide more stringent standards (herein after described as "incremental regulations" by The Geneva Association) for covered financial companies, including nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) after the FSOC determines that material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or the mix of its activities could pose a threat to the financial stability of the United States.¹ Covered companies also include the largest bank holding companies, including insurers affiliated with a depository bank through common corporate ownership or control.² In our view, for insurers, Sections 165 and 166 of the Act require the Federal Reserve to *establish more stringent requirements vis-à-vis other (non-covered) insurers*.

The Geneva Association – officially the "International Association for the Study of Insurance Economics" – was established in 1973. It is a not-for-profit association and it is the leading international insurance think tank for strategically important insurance and risk management issues. Through its research programmes, publications, and organisation of international meetings, it is the leading voice of the largest insurance and reinsurance groups worldwide in the dialogue with international institutions. Its Members include up to 90 CEOs of these organisations, including CEOs of U.S. companies and internationally active insurance groups with significant U.S. operations. The Geneva Association programmes include multiple forums

¹ Please see http://www.genevaassociation.org/PDF/General_Information/GA2011-PR-16-11.pdf Expert Submission to the Financial Stability Oversight Council (FSOC) on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies for comments submitted by The Geneva Association.

² The Federal Reserve intends to publish a future rulemaking for large thrift holding companies.

on key risk topics, including old age security, health and demographics, risk management, and very importantly financial stability.

The Geneva Association actively participates in the international dialogue on prudential regulation, and interfaces with the International Association of Insurance Supervisors (IAIS) as well as the Financial Stability Board (FSB) and other regional systemic risk bodies in an attempt to provide special insights on insurance matters and offer additional analytics that are aimed to increase the quality of future regulation. The Geneva Association has published a continuous stream of analyses, including various reports and special background papers, on how to deal with the financial crisis and its regulatory aftermath, lessons learned and actions to be considered. Please see our website www.genevaassociation.org for our publications and reports. Rules that provide a methodology to designate institutions for heightened supervision (which have been established by the FSOC)³ and the incremental regulations that would apply to covered companies are aimed at financial institutions with significant presence in the U.S., the single largest market for many of the financial activities that will be affected by the Dodd-Frank Act. Accordingly, the rules set by the U.S. regulatory authorities are relevant to the new global regulatory architecture, and should be compatible with frameworks being designed by other national jurisdictions and multinational and international organisations.

To achieve the overall objective of the Dodd-Frank Act, which in our view is to provide a more resilient global financial system, the new rules need to be developed in concert globally to avoid regulatory overlaps and arbitrage between systems in different jurisdictions to avoid duplication and eliminate gaps in regulation. As a practical matter, measures that address the domestic stability risks posed by financial companies in the U.S. are linked inextricably with similar risks posed by companies in other jurisdictions. Regulatory measures to provide more resilient domestic financial systems must be coordinated among jurisdictions and international standard setters to be effective. Accordingly, we are submitting our comments in the interest of contributing to coordination and cooperation among different players to design and implement effective regulation, enable efficient markets, and eliminate gaps in regulation that have previously contributed to instability and the need for government intervention funded by taxpayers.

Overview of the insurance industry and general comments on the proposed rule

The traditional insurance business has proven its ability to protect policyholders and absorb shocks from natural and man-made events without posing or extending systemic risk.⁴ Furthermore, insurers do not operate critical financial market utilities that are necessary to payments and clearing systems. Our analysis of the impact of the recent financial crisis on the industry and its capacity to absorb shocks was spread widely: traditional insurance activities were not the source of instability in global markets but rather a stabilising force.⁵ However, insurance companies suffer along with other investors when other important sectors of financial markets become distressed (banks, sovereign debtors, etc.). Thus, all financial services industry participants have a stake in the domestic and international efforts underway to provide a more resilient financial system through enhanced prudential standards and regulations.

Traditional insurance was not at the root of the financial crisis and showed great resilience throughout

Insurance is not banking. Its products and business models are different, its risks are different, its regulatory regimes have mitigated its risks effectively, and its remediation and resolution mechanisms have functioned well, without disorderly taxpayer bailouts. A national system of state-based regulation provides supervision in the areas targeted for enhancement in the Board's proposal (risk-based capital and leverage limits, liquidity requirements, counter-party exposure limits, risk management and risk committee requirements, stress test requirements,

³ Please see http://www.genevaassociation.org/PDF/General_Information/GA2011-PR-16-11.pdf for comments submitted to the FSOC by The Geneva Association on 19 December 2011, and press release.

⁴ Health insurance is not addressed by Dodd-Frank, and thus is excluded from our recommendations.

⁵ The Geneva Association (2010)

and debt-to-equity limits). In addition to promoting solvency and financial stability, the U.S. State-based regulatory mission puts policyholder protection foremost, while also facilitating an effective and efficient market place for insurance products.

Geneva Association analysis showed that insurance activities were not at the root of the financial crisis.⁶ However, the financial crisis experience also demonstrated that financial services companies, including insurers, might engage in quasi-banking activities that could lead to systemic risk if conducted on a massive scale without effective regulatory restraints or market discipline.⁷ Any such companies are candidates for heightened prudential regulation through Federal Reserve supervision.

With regard to insurance company remediation and resolutions, the Dodd-Frank Act, leaves these responsibilities to the states.⁸ Resolutions of failed insurance companies are long-running processes that allow time for planning, regulatory intervention, and where necessary, orderly runoff of policies in accord with the legal terms of each contract, and are structured to protect policyholder interests as the first objective. There is no known instance where mismanagement or weak oversight of traditional insurance activities led to an emergency taxpayer bailout of the enterprise to provide emergency liquidity to limit contagion to other financial institutions or the real economy.

General recommendations of The Geneva Association

It is appropriate to subject financial institutions that may pose a threat to the financial stability of the United States to more stringent standards compared with institutions that do not pose such risks. Our general recommendations concern the approach that the Federal Reserve Board is undertaking to implement sections 165 and 166 of the Dodd-Frank Act. Our four general recommendations set out below seek to put in place a process to develop effective regulations that: provide sufficient time to consider the risks to be mitigated and the regulatory regimes that address these risks; do not promote or extend competitive imbalances among different types of financial institutions; do not open new regulatory gaps or arbitrage possibilities; directly target the activities that raise systemic risk concerns; support public policy objectives to diversify risks within and among financial institutions, and encourage the role of the private sector in addressing areas such as ageing populations.

To support our recommendations, we provide a brief description of the insurance business model, including its history of stability, recovery and resolvability, and the backdrop of related initiatives that will impact internationally active insurers, including any insurers that may be designated by FSOC for heightened macro-prudential supervision by the Federal Reserve.

1) Incremental regulations should build on existing insurance regulatory regimes

The Board's proposed incremental regulations are intended to limit threats to the financial stability by reducing the probability that any covered company would fail. It is evident that the Board's proposal is based on its experience as the primary federal regulator of bank holding companies and state-chartered member banks, and from its central bank responsibilities to provide liquidity necessary to sustain orderly markets and protect the financial system, most recently from the experience of the financial crisis in 2007 – 2008.

The Board's proposal seeks to design more stringent standards compared to the standards in place for banks, and to apply these same incremental regulations to other types of financial

⁶ Please see *Considerations for identifying Systemically Important Financial Institutions in Insurance*, The Geneva Association, April 2011.

⁷ We have published case studies on insurers that experienced severe financial difficulties during the financial crisis. Some of the difficulties related to insurers' banking or quasi-banking activities, accompanied by regulatory issues. There has been no case where traditional insurance activities motivated a systemic bailout. Please see Appendix III for case study references.

⁸ Insurance bankruptcies are handled by state proceedings including receivership, conservatorship, rehabilitation or liquidation. Title II of the Dodd-Frank Act, provides for an orderly liquidation authority for other types of nonbank financial companies, but leaves insurer liquidation to the existing state codes.

institutions. The proposal assumes that insurance regulatory regimes are substantially similar to those in place for banking, which they are not.

Enhancements to bank regulations will not effectively represent more stringent standards for insurers. The Board's approach to layer incremental banking regulation over the insurance regime will disadvantage covered insurers' vis-à-vis banks by requiring them to comply with parallel sets of regulation at the base level, and to comply with incremental regulations that either are not calibrated with insurer risks, or are not effective to mitigate these insolvency risks. Accordingly, any incremental regulations for insurance must build on existing insurance regulation.

2) The Board should coordinate with domestic and international reform initiatives

The Board's incremental regulations are being proposed in a backdrop of domestic, multi-national and international initiatives to strengthen, update and harmonise financial architectures and regulation to respond to the lessons learned following the 2007 – 2008 crisis, and adapt to market developments. The largest and internationally active insurers, including any that may raise systemic risk concerns among regulators and policy makers, are subject to a multitude of regulatory initiatives to conform to a modernised financial architecture.

The U.S. national state-based system of insurance regulation is being reviewed through coordination among the state insurance commissioners Solvency Modernization Initiative (SMI).⁹ The SMI is reviewing key solvency components, which cover similar risk supervision topics addressed by the Board's proposal. These include risk-based capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance.

The Group of Twenty (G-20) is driving the regulatory agenda to put a more resilient financial architecture in place that is less prone to systemic breakdowns and contributes to sustainable economic growth. The G-20 has increased the scope and strengthened the charter of the Financial Stability Board to undertake the necessary operational tasks of global financial regulation. The International Association of Insurance Supervisors (IAIS) has taken the role for carving out the specificities of the insurance industry, including the development of a methodology to identify systemically important insurers for enhanced macro prudential oversight.¹⁰

The IAIS is working with its members to develop a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) to make group-wide supervision more effective, establish a comprehensive framework for supervisors to address group-wide risks, improve supervisory coordination across jurisdictions, and foster global convergence. In the European Union, enhanced capital solvency requirements and risk management practices are being phased-in that will directly impact insurers in the European markets, and insurance regulation in all major markets through an equivalency certification.¹¹

In order to design effective regulation pertinent to covered companies, it is essential to coordinate the development of incremental regulations or enhanced standards for the insurance industry – and for other types of nonbank covered companies -- with the related efforts cited above. The consequences of having inconsistent frameworks and standards could include an unjustified and proportionately higher regulatory burden on insurers, increased

consumer costs for insurance and less insurance cover, competitive imbalances and regulatory gaps which could be exploited for arbitrage, and have limited contribution to achieving financial stability. Such effects would not contribute to public policy initiatives seeking private sector

⁹ The SMI is being coordinated by the National Association of Insurance Commissioners. It began in June 2008 and is expected to be completed by year end 2012.

¹⁰ These bodies are developing key components, including a methodology to designate global systemically important financial institutions, and enhanced frameworks for supervision and resolution.

¹¹ Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), 25 November 2009.

contributions to address the challenges from ageing demographics, including the insurance products that guarantee income retirement solutions.

The Board should collaborate with interested parties, including the domestic insurance regulators and international standard setters, and call on the expertise of the industry to design appropriate incremental regulations that use the insurance industry business model and regulatory regime as its basis. Such coordination should continue to be exercised directly through participation in the international standard-setting groups, and through the Federal Insurance Office (FIO), and it should align with the timeframes and targets for enhancing the insurance policy architecture. The Board should make clear how it considers the most significant initiatives. The Geneva Association would be pleased to contribute to any such undertaking.

3. Incremental regulations should target areas of systemic risk

Past banking crises demonstrate the difficulty of reigning-in activities where short-term profits emanated from risks that were not properly priced or capitalised. Regulators' efforts to tighten supervisory constraints on potentially Systemically Risky Activities (pSRAs) were often met with strong industry and political opposition, and reforms could not be undertaken sufficiently early to avoid crisis-level events. Past examples of pSRAs conducted by some insurers include Credit Default Swaps derivatives and short-term funding issues.

In our view, the Board proposal would mainly impose blanket, one-size-fits-all, regulation for covered companies. Instead, we recommend that the Board should design incremental regulations to target pSRAs directly.¹² Any identification process for pSRAs and those companies carrying them out in such a manner that they are judged to pose systemic risk should be of the highest possible quality, transparent, predictable and reliable. Regulators need to explain why and how their decisions will provide additional protection to the financial system and what the cost to regulators, supervisors, insurance companies, policyholders and the financial market might be from any such designation. Such an approach would serve to avoid imposing redundant or non-effective incremental regulations that do not consider insurer risks and regulatory regimes.

An activities-based approach would follow several principles to ensure that the result is appropriate for the risks mitigated, and that the incremental benefits to financial stability are justified by the costs. Following such an approach provides several advantages compared with blanket "one-size-fits-all" supervision for an entire legal entity. For example, an activities based approach would provide a framework and tools for regulators to identify potentially systemically risky activities earlier, provide regulatory safeguards to constrain the consequent build-up of systemic risk in the system, and limit incentives to avoid regulation. The activities-based approach would be less costly to both insurers and regulators. And, it would contribute to public policy objectives seeking private sector support – for example insurance contributions for funding pension programs in an ageing society.

For further details, please see Section I: *An activities-based approach for supervision of non-traditional insurance Activities*.

4. More time is needed to develop incremental regulations for covered insurance groups

Based on the recommendations above, The Geneva Association believes a more in-depth analysis of the regulatory regime for insurance companies is necessary. We urge the Board to allocate sufficient time to undertake an activities-based approach to develop any incremental regulations for covered insurance companies. This process should be undertaken in collaboration with interested parties.

¹² pSRAs are activities that fulfil criteria set out by FSB and IAIS, which include size, interconnectedness, substitutability, and time.

Description of the insurance business model and resolution regimes

Insurance and banking business models are different. As a practical matter, their regulatory frameworks for capital, liquidity, risk management, and resolutions operate in fundamentally different ways, with regulation and resolution regimes calibrated to the risks inherent in their respective business models. Insurance resolutions are long running and the extended timeframe allows for planning and a relatively orderly process, with protection of policyholders, which mitigates the potential for systemic risk.¹³

No systemic risk from insurance activities

There is widespread agreement among international standards organisations, regulators, and the insurance industry that traditional insurance activities are not systemically risky.¹⁴ Not a single financial crisis has been triggered by any traditional insurance activity. The insurance business model – encompassing both insurers and reinsurers – has specific features that make it a source of stability in the financial system. These different circumstances require risk-mitigation via supervision appropriate to their respective business models, and are one of the reasons why bank supervision and insurance supervision have markedly different compliance features and regimes.

Insurance risk is idiosyncratic and generally uncorrelated with the economic cycle, and its solvency risks are not pro-cyclical. Insurance is funded by upfront premiums (a reverse production cycle), giving insurers strong operating cash flow without relying on wholesale, third party funding. The majority of insurance contracts are mid- to long-term (ranging from one-year for some property and casualty policies to decades for life insurance), with controlled payments to policyholders during the duration of the contract.

The insurance sector has a longer-term investment horizon compared to other types of financial institutions, a significant shock-absorbing capacity, and a strategy of matching assets and liabilities closely. In contrast to banks, insurers do not provide maturity transformation or significant credit intermediation since they do not hold market share concentrations in consumer or commercial credit, and do not provide transaction clearing or registration services. Insurance companies are not essential to operate the payments system or other financial market utilities. Insurance policies are booked as estimated liabilities, priced according to rigorous actuarial standards or underwriting informed by past experience, and reserves for estimated claims are accumulated during the life of the policy.

The traditional insurance business

Traditional insurance activities have features that either prevent or constrain policyholder discretion to make cash demands at will to collect on a policy.¹⁵ Property and casualty claims are triggered by external events, such as an accident, fire, earthquake or wind damage, must occur for policyholders receive pay-outs.

For life insurance and annuities, there are usually significant surrender penalties often accompanied with tax consequences. In the case of discretionary life insurance redemptions, policyholders bear the investment risk. The accumulated value in life insurance policies can be cashed early under some contractual conditions, but the insured cannot replace the policy on the same terms and price. Under reserving for annuities may occur, but the consequences are predictable ahead of time to facilitate early mitigation, and there are no cases where this has led to systemic concerns.

¹³ Furthermore, state-based industry-funded guaranty schemes are in place to protect consumers in the U.S.

¹⁴ In its November 2010 Insurance and Financial Stability report, the IAIS notes that traditional insurance is unlikely to become a source of systemic risk “The arguments in support of this derive mainly from the nature of insurance liabilities and the fact that in the normal course of business insurers do not use excessive leverage, while investments are funded in general by premium income and held to match liabilities.

¹⁵ The frequently cited Ethias case does not exemplify an “insurance run”. The redemptions were against a bank-like deposit product, callable on demand without penalty. Please see Annex III for case study references.

The insurance industry distributes and reduces financial risk

There are several features of traditional insurance activities that prevent systemic risk propagation or contagion to the broader financial system.¹⁶ These stabilising features include underwriting large pools of uncorrelated risks, premiums paid “up front” and invested in uncorrelated risks structured to match liabilities, payments to policyholders must be triggered by an insurable event (property and casualty), and disincentives to surrender life insurance policies or annuities early. Assets and liabilities are tied-together, with the effect to ensure that assets are available to protect policyholders in the case of company impairment. A main feature of traditional insurance is the requirement for a financial interest in the insured life or property. Moral hazard is managed through risk sharing, for example higher deductibles can reduce property and casualty premiums by increasing the risk borne by the policyholder.

Products that meet these features have not been sources of contagious runs or systemic risk to economic activity. Of importance, Credit Default Swaps (CDS) do not meet several traditional insurance features, such as the policyholder requirement to have an insurable interest, since they can be purchased for speculation and traded among parties that may or may not have an underlying interest in the default of the credit, and the amounts protected can exceed the underlying amount. Guarantees against the default of a borrower do not meet the insurable interest criteria.¹⁷ Accordingly, the CFTC and SEC have jointly defined a carve-out for insurance to exclude CDS from regulation as an insurance activity lacking an insurable interest.

The banking business model’s dependency on the collectability of loans and exposure to credit cycles can lead to widespread and abrupt liquidity and capital insolvencies in the industry, with losses absorbed by investors, creditors, and the FDIC. There have been episodic cases having systemic implications leading to government protection of uninsured bank creditors and taxpayer funded bailouts. The banking business model is not able to accumulate sufficient capital to protect against all such crises. Conversely, the insurance model has absorbed catastrophic loss events. In the last 20 years, the insurance industry has withstood a series of such events without widespread defaults on policyholder claims, liquidity shortfalls, or taxpayer bailouts.

Although the insurance business is affected by macro-economic conditions, its solvency is less sensitive to the business cycle compared with banks. Life insurance products with long-term commitments may face extension risk where the longest investment maturities fall short of policy pay-outs. The property and casualty pricing cycle is driven by loss experience, and catastrophes are one factor in insurance pricing and earnings cycles. When insurers have under-estimated claims for losses, policy prices tend to increase. As expenses decrease and investments are accumulated, prices tend to stabilise or decrease, and new capital and participants often enter the industry. The flow of capital into the insurance industry, and thus its loss-absorbing capacity, is globalised.

Please see Table I, below.¹⁸ The insurance industry has absorbed high-cost and unpredictable natural and man-made events without posing any systemic risk concerns. In the last ten years, these events include 9/11, and several severe hurricanes and earthquakes within a relatively short period, including three hurricanes in the U.S. in 2005. One of the biggest single loss events – 9/11 - totally unexpected in nature was successfully absorbed, with European insurance companies paying a major part of the claims. No insurance failures worth mentioning were recorded, and the global (re)insurance capital base was restored quickly. The event demonstrated that the presence of a strong insurance industry with an appropriate regulatory and supervisory framework is vital to public welfare, and showed the flexibility of the insurance industry when faced with an unthinkable and outsized event.¹⁹

¹⁶ See Risk Management for Enterprises and Individuals, Baranoff, Brockett, and Kahane, 2009, chapter 6.

¹⁷ For discussion of traditional and non-traditional insurance activities, see Insurance and Financial Stability, International Association of Insurance Supervisors, November 2011, 3.1 *the traditional insurance business*.

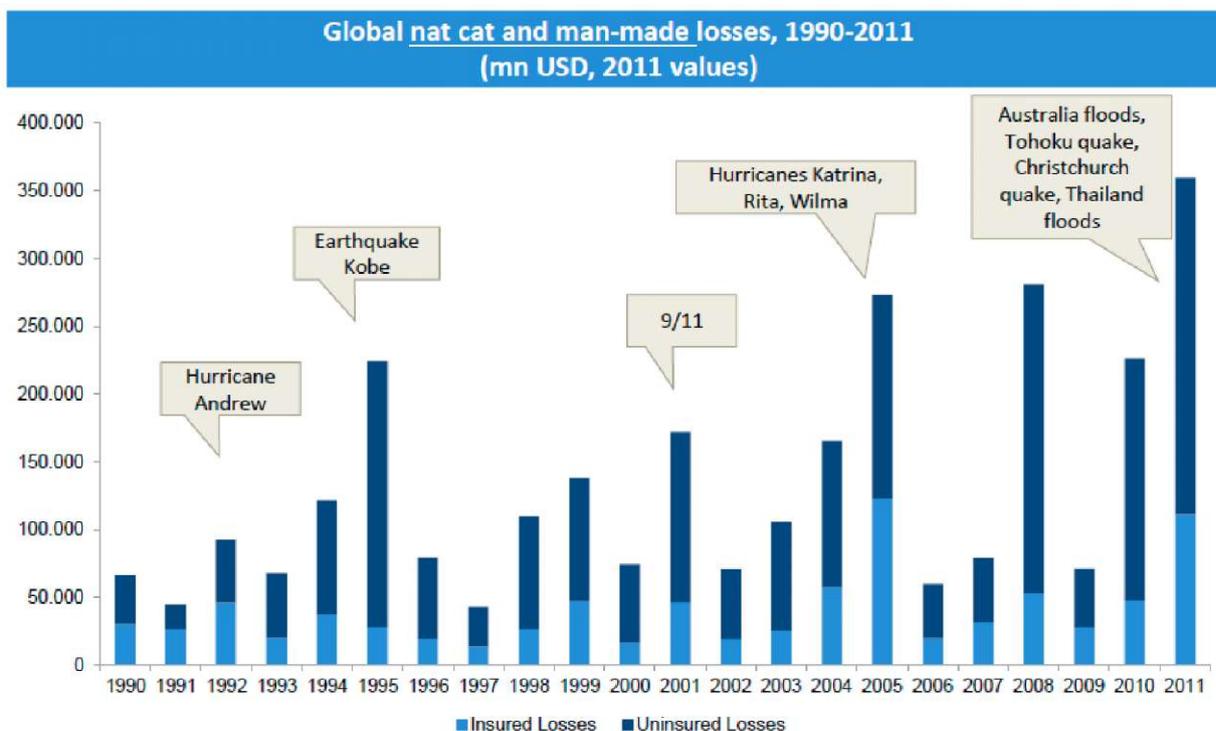
¹⁸ For example, insurance covered roughly 80 percent of the economic losses from the February 2011 earthquake in New Zealand, more than four times the 17 percent covered by insurance for the March Tohoku quake in Japan.

¹⁹ From *The Geneva Association Reports, Risk and Insurance Research: September 11 – Ten Years On*, p.2.

Note the relationship between insured losses and economic losses reflects perception of risk, and the cost of insurance cover for discretionary insurance products. Insurer operating costs, including regulatory compliance costs, increase policy prices and can reduce the amount of insurance cover, so it is critical to consider the cost of regulation against the systemic risks mitigated.

Table I²⁰

In the last 20 years major nat cat events occurred



Risk-based capital standards

Capital frameworks in force for the U.S. insurance industry and those for the banking industry share common objectives, and have followed similar development and implementation timeframes, informed by events that exposed unanticipated risks or capital deficiencies. Both insurance and banking risk-based capital models provide minimum regulatory requirements to ensure that each regulated financial institution holds adequate capital for its financial and operational risks to reduce its probability of failure, and consistent requirements for all participants within the respective industry contribute to fair competition. Each framework includes progressive triggers for increasingly stringent intervention when capital levels fall below minimum thresholds.

The insurance Risk-based Capital (RBC) standard includes four levels of intervention, which become increasingly severe as capital adequacy declines, please refer to Annex I: *NAIC Supervisory Ladder of Intervention*. The RBC ratio for the insurance industry is determined by comparing actual capital to a risk-adjusted capital requirement. This framework is conceptually similar to the Prompt Corrective Action regime for banks, which also mandates a ladder of intervention that becomes increasing severe as capital adequacy deteriorates. For insurance companies, mandatory supervisory control instigates when actual capital falls below 70 per cent of the risk weighted capital requirement, well before an impaired company becomes

²⁰ Table I from Swiss Re and Munich Re analysis, also see *New Swiss Re report reveals low earthquake insurance penetration globally, even in countries with high seismic risk*, news release 17 January 2012.

capitally insolvent. For banks, a mandatory failure process is initiated when tangible equity as a per cent of assets falls below two per cent.

There are differences and contrasts in the risk-based capital frameworks in place for insurers versus banks that reflect the different business models and risks in each industry. The insurance RBC model risk-weights assets, liabilities, off-balance-sheet accounts and related activities - for example underwriting risk experience - to determine required capital, whereas the banking RBC only risk-weights on and off the balance sheet assets. The insurance and banking frameworks are based on different risk weighting factors, and their operations require different management information systems data inputs and disclosure requirements and are measured using different accounting standards. For the insurance industry, the RBC ratios compare "Total Adjusted Capital" (TAC). TAC (numerator) is the accounting capital held by the company, according to industry accounting standards. Risk weightings are reflected in the ratio denominator "Authorised Control Level" (ACL), which is determined by assigning an amount of capital for each activity according to its risk weighting. The Basel risk-based capital ratios are calculated by dividing loss-absorbing capital (numerator), by risk-weighted assets. For each capital model, the resulting ratio is then compared to threshold level triggers. Please see Annex I for balance sheet accounts and other insurer activities that contribute to an insurer' regulatory capital requirement.

Capital standards for insurers should consider the diminishing returns from raising capital to decrease the probability of failure. In any enterprise, capital can reduce the probability of failure. However, increasing capital above a threshold can become counter-productive, because insurance depends on the law of large numbers for diversification of uncorrelated idiosyncratic risks. Larger pools reduce the probability that an insurer will significantly miscalculate future loss predictions. If set too high, capital hurdles limit the ability to take advantage of large numbers, pushing the risks into the business by constraining a company's ability to pool risks and increase confidence in its risk estimates and policy prices, and reach an optimum size.

While there is an argument that similar risks should have similar capital consequences, there are also examples that justify differential capital requirements tied to the inherent risks. For example, life insurance seeks to match the duration of very long life expectancy contracts, with long-term asset investments. One challenge is finding assets with sufficiently long maturities, and the challenge is becoming greater with increasing life expectancies. In this case, applying higher capital requirements to long-term investments is counter-productive, and could increase the riskiness of the business and consumer cost for life insurance policies.

Industry accounting standards

Accounting practices is another area of significant difference between insurance and banking.

There are different accounting standards in force for domestic and international financial entities (Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) to name two), and there are industry-specific standards as well, namely Statements of Statutory Accounting Principles (SAP), which form the reporting basis for Statements of Statutory Accounting Practices (STAT) for the U.S. insurance industry. The FSOC recognises that not all industries use GAAP, and it has stated that it intends to generally apply GAAP to apply the stage 1 criteria, when such information is available, or otherwise to rely on SAP. And, it expects to review financial statements prepared in accordance with SAP, in Stages 2 and 3 if applicable.²¹

There is a long-running movement towards convergence in insurance accounting principles and disclosure practices. And, internationally active insurance groups may be subject to reporting obligations under all three accounting frameworks.²² The SAP system requires an

²¹ Financial Stability Oversight Council 12 CFR Part 1310, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, p. 32.

²² In July 2010, the IASB issued an exposure draft on the development of global accounting standard for insurance contracts. In September 2010, the FASB issued a Discussion Paper on the same topic.

evaluation of GAAP. Deviations reflect an effort to provide a solvency perspective on valuation. Fundamental differences between systems arise regarding the purposes and audiences of the accounting statements. These differences are mainly differences in transaction recognition and measurement.

Investors and the financial community, including banks and insurance companies, use financial statements prepared under IFRS and under U.S. GAAP. The main focus of this type of accounting is on the reporting financial institution's ability to continue operating ("going concern") and the sustainability of its earnings. Conversely, Statements of Statutory Accounting Principles (SAP) form the reporting basis for insurance industry Statutory Accounting (STAT) financial statements, which are designed to ensure that regulators can properly supervise the company and perform their supervisory functions. Rather than focusing on the sustainability of earnings, STAT focuses on solvency and the ability to pay claims with an emphasis on liquidity of the assets reported to ensure the insurer can meet policyholder obligations. STAT financial statements are generally more conservative than GAAP and IFRS financial statements.

There are numerous examples of how the GAAP and IFRS accounting systems differ from STAT, and how these differences are evident in disclosed financial statements. In the view of the insurance industry, STAT provides a more conservative view that more appropriately reflects the insurance business model. By way of example, insurance companies seek to closely match assets (purchased with policy holder premiums) with estimated claims (also referred to as insurance liabilities). Some insurance contracts, for example life insurance policies, have a very long estimated pay-out horizon, which is based on remaining life expectancy. As a result, life companies are the largest investors in long-term assets, primarily bonds, and they account for these on an amortised cost basis (held to maturity).

Risk management

The proposed regulations focus on several interrelated governance and risk-management topics, which include liquidity requirements, single-counterparty exposure limits, and risk management and risk committee requirements - and by extension capital standards and debt-to equity limits.

The International Association of Insurance Supervisors (IAIS), and its members developed the Insurance Core Principles (ICPs) and the IAIS member jurisdictions adopt them for their day-to-day supervision. The IMF and World Bank assess national insurance supervisory regimes against the ICPs for Financial Sector Assessment Programs (FSAP). The Financial Stability Board (FSB) also uses the ICPs for thematic peer reviews.²³ National jurisdictions and other organisations conduct self-reviews based on the ICPs to strengthen domestic regulation and conform to international standards and best practices. Two Core Principles deal specifically with risk management and corporate governance, and set out the good practices regarding an array of related considerations, including transparency and the role and responsibilities of the Board, and appointment of a Chief Risk Officer (CRO) with appropriate reporting lines.²⁴

The recent economic crisis has led to initiatives to improve risk management within financial institutions to regain and sustain financial stability. In April 2009 the Chief Risk Officers Forum (CRO Forum) considered the lessons learned and reforms needed.²⁵ In 2008, U.S. state regulators initiated the Solvency Modernization Initiative to improve the solvency framework. The SMI includes the rules and practices to ensure accountability, fairness, and transparency in an insurer's relationship with its stakeholders. Concluding an FSAP review of U.S. insurance regulation in 2009 – 2010, the IMF identified areas for enhancement, including suitability criteria for key persons, external audit function requirements, and for maintaining risk

²³ The IMF, World Bank, and the FSB recognise key standards and codes for these programs, please see http://www.financialstabilityboard.org/cos/key_standards.htm, Key Standards for Sound Financial Institutions, which also include the BCBS Core Principles for Effective Banking Supervision, and the IADI Core Principles for Effective Deposit Insurance Systems and the IOSCO Objectives and Principles of Securities Regulation.

²⁴ Insurance Core Principles, Standards, Guidance and Assessment Methodology, numbers 7 and 8, International Association of Insurance Supervisors (2011).

²⁵ Insurance Risk Management Response to the Financial Crisis, CRO Forum (2009) 'Insurance Risk Management Response to the Financial Crisis'.

management systems capable of identifying, measuring, assessing, reporting and controlling risk.²⁶ In 2010, model regulations were updated in three corporate governance areas, including external auditor independency, board responsibilities, and internal controls.

An SMI Corporate Governance working group was formed in 2009 to review high-level principles, review the IAIS corporate governance principles and standards to provide input to the IAIS Governance and Compliance Subcommittee, and identify improvements to the regulatory system, including education for insurer Board members and senior managers, and regulators. The Corporate Governance working group has published a white paper outlining high-level principles for use in U.S. insurance regulation, which include the roles and responsibilities of the Board of Directors and senior management and risk management and internal control functions.²⁷ The White Paper discussion is expected to lead to updates of several related areas in the SMI.

Early remediation and resolutions in insurance

The number and frequency of failures have been very low for the insurance industry, especially when compared to bank failures, and the volatility of insurance failures have been less correlated with the economic cycle. In 2007 – 2008, only 28 of the roughly 8000 insurers became insolvent. This is an insolvency rate of 0.35 per cent. During those same two years, 178 banks out of about 8,500 failed, or 2.1 of the industry. Thus, the bank failure rate was six times greater than the insurance company rate.²⁸

When compared with the banking industry, the frequency of insurance impairment has also been very low. These facts can be illustrated by “problem” bank data from the FDIC, and data on financially impaired property and casualty insurers, and impaired health and life insurance companies from AM Best. According to the FDIC²⁹, since 1990, the impairment rate for banks ranged from less than one per cent (2004, 2005, and 2006) to more than 11 per cent in 2010 and 2011. According to AM Best³⁰, the impairment rate for property and casualty during this same time period has ranged from about 0.1 per cent to about 1.8 per cent. The impairment rate for life and health insurers from 1990 to 2010 ranged from about 0.3 per cent to around 3 per cent.³¹ This shows that impairment rates are considerably lower, and are less volatile in business cycle downturns compared with banks.

Resolutions for failing insurance companies are stable processes

Title II of the Dodd-Frank Act provides for orderly liquidation authority applicable to some types of financial institutions. Insurers are not included in Title II, as their existing, state-based, resolution regimes have proved effective.

Resolution schemes for failing insurance companies are stable processes with clearly limited economic impact. Insurance balance sheets do not react to stress in the same way as banking balance sheets. No accelerated wind-down processes are required as non-viable companies can wind down over time, typically a period of years, and because their activities are mainly funded by prepaid policyholder premiums, they do not require emergency liquidity injections or taxpayer support to protect the financial system from contagion. Illiquidity, a driving factor that

²⁶ Please see <http://www.imf.org/external/pubs/cat/longres.cfm?sk=23868.0> for the IMF corporate governance findings.

²⁷ Please see NAIC (2012).

²⁸ FSOC 2011 Annual Report, p.61. Please note that the bank failure statistics only include insured depository institutions.

²⁹ FDIC *Quarterly Banking Profile*, Third Quarter 2011.

³⁰ The FDIC problem bank data includes commercial banks and savings institutions with CAMELS ratings of 4 or 5. According to Federal bank regulators, these institutions have financial, operational, or managerial weaknesses that threaten their continued viability. AM Best defines Financially Impaired Companies as the first official regulatory action taken by an insurance department, for a variety of causes, including impaired ability to conduct normal insurance operations, inadequate capital and surplus, or where concerns on general financial condition have triggered regulatory concern.

³¹ Best's Special Reports, May 2, 2011 (U.S. Property and Casualty) and May 23, 2011 (U.S. Health and Life).

sometimes motivates overnight bailouts of banking activities, has not been an issue in the wind down of traditional insurance as noted above.³²

Institutions that can demonstrate that they can be resolved in an orderly fashion, without contagion to other financial institutions and without government assistance, cannot and should not be deemed a SIFI. There will be no source of systemic risk and no threat to the financial system if a failure becomes an orderly process.³³

COMMENTS ON EACH SECTION

Insurance regulation should provide the base on which to design incremental regulations that “are more stringent” compared with other (non-covered) insurers. Our comments below follow from this recommended starting point.

I. An activities-based approach for supervision of non-traditional insurance activities

Past banking crises demonstrate the difficulty of reigning-in activities where short-term profits emanated from risks that were not properly priced or capitalised. Examples in the U.S. banking industry include speculative construction and development, mismatch in asset-liability maturities and pricing, and mortgage financing with repayments contingent on ever-rising prices and refinancing opportunities. Regulators’ efforts to tighten supervisory constraints on these activities were often met with strong industry and political opposition, and reforms could not be fully undertaken sufficiently early to avoid crisis-level events. Past examples of pSRAs conducted by insurers include Credit Default Swaps derivatives - and short-term funding issues.

The Geneva Association recommends that the Board should undertake an “activities-based” methodology³⁴ that can be universally applied to all financial institutions to identify potentially systemically risky activities (and the institutions that conduct them)³⁵ and second, apply specific indicators tailored to effectively identify and supervise systemically risky activities.³⁶ It is based on an analysis of all activities carried out by the institution. In the context of supervision, this approach first identifies activities that could potentially lead to systemic risk, and then targets these activities and the financial institutions that conduct them for risk-appropriate supervision taking into account the costs and consequences.³⁷ The first phase should be conducted by macro-surveillance bodies in their role of monitoring markets to identify potentially Systemically Risky Activities (pSRAs). Targeting supervision of pSRAs in this manner provides for earlier identification of institutions engaged in pSRAs before the activities and institutions reach a scale that may pose a threat to financial stability, and motivates a more effective use of supervisory resources. Waiting until an institution is “designated” or reaches the financial holding company size threshold allows for the build-up of systemic pressure in the financial system, which could compound when the activities that cause an institution to be designated are also spreading or proliferating among other covered institutions and in smaller, “not-designated” financial institutions or holding companies.

This approach has many advantages over alternatives that add new layers of supervision or capital over an entire company where even a small part of its business includes activities that

³² See *Insurance and Resolutions in Light of the Systemic Risk Debate*, on The Geneva Association website, at <http://www.genevaassociation.org/PDF/Bookand/Monographs/GA2012>

³³ See statement of Sheila C. Bair, FDIC Chairman, before the House Subcommittee on Financial Institutions and Consumer Credit.

³⁴ See *Considerations for Identifying Systemically Important Financial Institutions in Insurance*, The Geneva Association, April 2011.

³⁵ In the context of U.S. regulation, these would automatically include all covered companies.

³⁶ The Financial Stability Oversight Council (FSOC) is charged with designating nonbank financial companies that could pose a threat to the financial stability of the United States for prudential oversight by the Federal Reserve.

³⁷ This approach could also be applied to subsidiaries that engage in pSRAs, and could have identified activities that subsequently contributed to the 2008 financial crisis at an early stage.

could cause systemic risk if conducted on a massive scale without appropriate supervisory oversight. Such an approach: targets the potential source of systemic risk; promotes efficient regulation and competitive markets; allows careful consideration of the impact on the industry, and allows for the specificities of the insurance industry. There are other advantages of an activities-based approach to supervise activities and institutions that may pose systemic risk or potential. Such an approach is globally applicable, does not depend on underlying accounting principles, captures business below any pre-determined size threshold, captures on- and off-balance-sheet activities, reduces regulatory arbitrage potential, and promotes risk-adequate pricing and therefore risk-relevant behaviour. A regular reassessment among regulators captures changes in behaviour and new activities.

The Geneva Association recommends that the Federal Reserve should undertake an activities-based approach to develop incremental standards, which should consider the following points:

- Start with the insurance regulatory frameworks as the base on which to design any incremental regulations for covered insurers.
- Put in place a process to identify potentially Systemically Risky Activities (pSRAs) within covered insurers (or for all regulated financial institutions).
- Distinguish between pSRAs, such as derivatives trading for purposes other than hedging that can be supervised at the legal entity level on a functional basis versus activities, such as liquidity risk management that require consolidated or group-wide supervision.
- Work with the insurance industry and its regulators to design any enhancements targeted for pSRAs conducted in each insurer.³⁸
- Calibrate incremental regulations with the relative risks posed by pSRAs, considering the regulatory regimes in place to supervise the risk therefrom tailored on a covered-company-by-covered-company basis.
- Rely on the state supervisor for supervising pSRAs and SRAs within insurer legal entities. In the case of covered insurers, the Board would coordinate with the state authorities to design enhancements that are targeted to those activities that could pose systemic risk. The group supervisor should be responsible for any foreign non-bank covered companies.
- Legal entity or enterprise level incremental regulations should be considered for covered companies that contribute essential services to payments systems that must continually function and cannot be interrupted without destabilising severe and immediate consequences for the broader financial services industry.

II. Overview of the proposal

After taking into account existing regulations in place for the insurance industry, the Board should only consider incremental regulations (enhanced standards) that provide more stringent regulations. Any proposed incremental regulations should take into account the burdens versus the risks mitigated, and recognise the domestic and international efforts to modernise regulatory regimes for covered insurers.

Subjecting a covered insurance company to regulations which are incremental to bank regulation would needlessly impose burdens that are neither relevant nor proportional to the risks. The compliance burden would be higher for insurers' vis-à-vis banks, because it would require covered insurers to adopt multiple risk-management systems, and reconcile results from multiple standards and risk management models. Such reconciliations would not be necessary for banks because the incremental regulations build on existing bank regulation.

³⁸ Some insurers that conduct pSRAs may be designated by FSOC, as presumably the pSRAs are conducted on a scale that they meet the FSOC designation stage 3 criteria.

This asymmetrical burden would result in competitive disadvantages to insurers. There could be several unintended consequences, and would limit the industry's ability to serve as a stabilising shock absorber, with consequences for businesses, consumers, economic growth, and taxpayers. Such an approach would lead to the creation of arbitrage possibilities and an uneven playing field. It would also provide asymmetrical incentives for insurers to disengage from banking activities.

The Board should follow an approach that targets potentially Systemically Risky Activities (pSRAs). The regulators would need to agree on a process to develop a process to identify pSRAs within the financial services industry. This could be coordinated among the state insurance supervisors, and by the Federal Insurance Office for activities and incremental regulations relevant to internationally active insurance groups where the U.S. has jurisdiction.

Further to this point, the effects of blanket regulation can already be seen; where some covered nonbank financial companies have incentives to divest business units that add new layers of regulation, regardless of systemic potential. An FSOC designation alone should not distinguish SRAs and pSRAs.³⁹ Taking a more holistic approach to identifying and supervising the institutions that conduct pSRAs could lead to early identification and remediation of problems, avoid contagion among financial institutions, and avoid taxpayer bailouts.

III. Risk-Based Capital Requirements and Leverage Limits

Operating insurance companies have processes in place for compliance with regulatory capital standards. The Board should rely on insurer risk-based capital models and the risk-weights therein, and consult with insurance sector capital experts to allocate sufficient time to consider any incremental group capital requirements. Banking companies and insurers each have distinctly designed capital frameworks that consider the risks involved. It is not meaningful to apply the banking capital framework to assess the capital needs for the insurance balance sheet, just as it would not be meaningful to use the insurance capital framework to assess the capital needs of a bank. Modifying frameworks would require banks and insurance companies to make extensive changes to their management information systems, risk management oversight processes, and internal and external disclosures. Underlying accounting differences would further complicate the effort.

An insurer that is fully capitalised for its insurance risks may falsely appear to be either under-capitalised or excessively capitalised according to the bank Basel III standards. The Board's proposed rule provides supervisory triggers calculated on the bank capital definitions for risk-based capital and leverage ratios.⁴⁰ The Basel capital models are geared to risks inherent in the banking business model for institutions that widely engage in banking activities, and they omit activities that would require capital for certain insurance activities. Having to comply with multiple standards will not mitigate insolvency risks and will confuse markets regarding the risks inherent in the insurance business model. Please see Annex I for action triggers set to identify and correct capital deficiencies early, and put a company into receivership or conservatorship as the final trigger, and Annex II for details on how insurance activities translate into required capital.

The BCBS framework should only be considered for banking subsidiaries within an insurance group, and should only be applied to banking entities within an insurance group if the insurance business does not provide risk mitigation. Enhanced insurance capital requirements should only be considered for risks emerging from any pSRA(s). The Board should consider the risks and activities that led the FSOC to designate an insurer, and then design incremental regulations that are targeted to mitigate risk posed. This consideration should also build upon the existing risk based capital regimes of any pSRAs. The Board should consider the level (size, internal risk-management, supervisory regimes) of any pSRAs.

³⁹ Presumably, pSRA would become SRA in companies designated by the FSOC; see our comments to FSOC on 12 CFR Part 1310, on 19 December 2011.

⁴⁰ For example, see Table 4 in the proposed rule, *Early Remediation Triggers*, and Table 5, *Remedial Actions*.

Leverage ratios – for banks, equity to assets - are not used in this form to assess or control insurance risks. Such measures should exclude technical provisions and policyholder liabilities (which emerge due to insurable events) should be excluded from the calculation. In contrast to banks, policyholder liabilities and technical provisions are not correlated to the economic cycle, and the risks from these are not mitigated by capital.

IV. Liquidity requirements

Liquidity risk management is distinct from capital management, and the insurance business has different risk profiles compared to banks, as the business model is self-funding and thereby inherently less exposed to liquidity risk.

The Board should take into account the existing regulation. The proposed liquidity management requirements are essentially redundant to reserve requirements imposed by state insurance supervisors. The Board should defer to state regulators on liquidity matters arising from a covered company's core insurance activities. The applicability of CFPs should be limited to risks arising from a covered company's pSRAs.

The provisions of the proposed rules relating to liquidity and liquidity risk management do not take into account the essential differences in the liquidity risk profile between a covered nonbank financial company and a Large BHC. For example, life insurers' liabilities are predominantly long-dated (as in the case of a life insurance policy), rather than short-dated (as in the case of a bank deposit), making it unlikely that a life insurer will be subject to a "liquidity" problem arising from a lack of short-term funding from third parties including other financial institutions. Instead, the liquidity risk for a life insurer is focused on the possibility of elevated level of surrenders by policyholders at guaranteed cash surrender values that may create growing liquidity pressures over time. Likewise, there is very limited liquidity risk for property and casualty non-life activities.

We request that the final rules explicitly provide for tailoring of the liquidity and liquidity risk management requirements based on the actual risk profile of a covered company and recognize the need for a covered company to design its risk management processes, including liquidity stress tests, to address the liquidity events that could be problematic given the specific business model and products of the company.

Further, the Board notes that it will implement Basel III liquidity ratio calculations in future rule makings.⁴¹ Since these calculations do not align properly with the liquidity risk profiles of insurers and insurance holding companies, these rulemakings should be further delayed until further study of the liquidity risk profiles of insurers is complete.

V. Single-Counterparty Exposure Limits

Not all subsidiaries within an insurance group engage in derivatives trading. Single-counterparty exposure limits should only be applicable to subsidiaries that engage in speculative derivatives trading pSRAs, which would exclude hedging for traditional insurance activities, including interest rates and foreign currency exposures.⁴² The same concept should be applied as for the determination of the scope of consolidation. Covered companies should be able to use internal estimates for collateral haircuts. Major counterparties would be other covered companies that engage in pSRAs.

States are in the process of adopting the NAIC holding company model regulation as part of the Solvency Modernization Initiative. The Board should consider following the NAIC's lead as it applies to insurance companies within a covered company, instead of adopting the Regulation Y change of control definitions.

⁴¹ See Section II, *Overview of the Proposal*.

⁴² Hedging of commercial risk is specifically excluded from the definition of a "Major Swap Participant" in the Dodd-Frank Act.

VI. Risk Management and risk committee requirements

Robust enterprise-wide stress testing, which should be a best practice for covered companies, necessitates that oversight of capital, liquidity, and stress testing be performed by the same company board-level committee, which is in accordance with the Federal Reserve Board's Comprehensive Capital Analysis and Review (CCAR). However, the proposed rule on risk management and risk committee requirements would require a covered company to have a standalone risk committee of the company board. Therefore the proposed rule should be amended to allow a covered company to combine its risk and finance committees in order to ensure strong oversight of capital, liquidity, and stress testing.

The Board should consider the related initiatives being undertaken in response to the recent FSAP recommendations and efforts to modernize corporate governance and risk management principles. An enterprise-wide risk management review is not appropriate for a pSRA that is primarily transacting insurance. Instead, the Board's enhanced regulation and corporate governance standards applicable to an insurance company's risk management should focus on the company's pSRA activities, including those non-insurance activities that caused it to be designated by the FSOC.

VII. Stress Test Requirements

The Board should rely on existing models and methodologies for estimating losses in a covered insurer. Any incremental stress test requirements should only be applied to banking or banking-like activities but not to the insurance activities, as insurance activities are not sources of systemic risk, and the insurance balance sheet behaves very differently compared to banks.

Blanket requirements that do not consider the relative risks within an insurance group are not effective to identify potential capital deficiencies, and applying bank measures can lead to misleading conclusions and inappropriate regulatory responses regarding a target level, competitive dislocations, and market confusion. Different regulatory regimes and accounting rules would require protracted implementation schedules, and the result would not correspond with the risks. Any incremental requirements should only apply to insurers' bank subsidiaries or banking-like activities conducted by insurance groups. The Board might consider requiring two separate stress-tests that it would only apply for these activities. One test would be predefined and consider the most relevant risks per participant. In the case of an insurance group with banking or banking-like activities, the second test would assess the impact of banking activities on the insurance activities, and should take into account ring-fencing structures that ensure that reserves and assets are tied-to claims liabilities, and insurer obligations to demonstrate comprehensive policy holder protection.

Potential burden stemming from the requirements to submit internal data include the availability of requisite data. Inter-group transactions have to be considered separately. The lack of having a group supervisor can generate legal issues and competency conflicts.

The complexity of stress tests does not correlate with the amount of total assets of a company, but rather to the type of activities which need to be tested and reported-on. Since insurance activities are not sources of systemic risk but certain banking or quasi-banking activities may pose systemic risk potential, the stress test must focus on these pSRA activities. Complexity is further determined by the company's structure, including the number and activities of subsidiaries and branches and the chosen business model, not the size.

Publication of stress-test results must be very carefully thought through. Any additional reporting requires an efficient planning process to implement system enhancements. A phased-in of any additional stress test scenarios should be tailored to individual company considerations to help the companies automate processes as much as possible.

VIII. Debt to Equity Limits for Certain Covered Companies

The debt to equity requirements of an insurance company and the impact of debt issuance on capital adequacy and on the financial condition of an insurance company differ significantly

from that of a bank. The provisions of the proposed rule regarding debt to equity must be activity-based.

IX. Early Remediation

There is already an effective early remediation process with similar procedures in place in the insurance regulation framework. The Dodd-Frank Act Title II orderly liquidation authority provisions do not apply to insurers. The Board should clarify how Title II would apply to covered insurers affiliated with banks.

We would be pleased to constructively contribute to the development of incremental regulations appropriate for covered companies that are engaged in insurance activities by offering our research expertise and the ability to directly access the world's largest insurance groups.

Yours sincerely,



Patrick M. Liedtke
Secretary General and Managing Director



Donald Inscoe
U.S. Regulatory Policy Expert

ANNEX I

Insurance and bank⁴³ risk-based capital intervention triggers

Categories	Capital Thresholds ^A	Major Restrictions
1. Well capitalized	RBC \geq 10% and LR \geq 5%	None
2. Adequately Capitalized	RBC \geq 8% and LR \geq 4%	None
3. Undercapitalized	RBC < 8% or LR < 4%	<ol style="list-style-type: none"> 1. Capital Restoration plan 2. Suspend dividends 3. Restrict asset growth 4. Prior approval for expansion
4. Significantly Undercapitalized	RBC < 6% or LR < 3%	<ol style="list-style-type: none"> 1. Require recapitalization 2. Restrict transactions with affiliates 3. Restrict interest rates paid 4. Further restrict asset growth 5. Prohibit deposits from correspondents 6. Hire, replace senior management
5. Critically Undercapitalized	$\frac{\text{tangible equity}}{\text{total assets}} \leq 2\%$	Receivership or conservatorship within 90 days unless exempted by primary regulator and FDIC

^ARBC = risk-based capital ratio: total capital, including equity, subordinated debt, and preferred stock, divided by risk-weighted assets.

LR = leverage ratio: tier 1 capital, including equity capital, divided by total average assets

NAIC Supervisory ladder of intervention⁴⁴

TAC / ACL ¹	Status	Consequence
> 200%	No action	<ul style="list-style-type: none"> • No regulatory consequences.
150% – 200%	Company Action Level	<ul style="list-style-type: none"> • Insurer to submit a comprehensive RBC² Plan to its regulator identifying, among other things, the cause of the capital deficiency and proposing specific corrective measures designed to solve the problem.
100% – 150%	Regulatory Action Level	<ul style="list-style-type: none"> • Insurer to submit a (revised) RBC Plan. • Regulator authorised to conduct a comprehensive examination of the company's operations and the (revised) RBC Plan. • Regulator empowered to order the company to take remedial actions.
70% – 100%	Authorised Control Level	<ul style="list-style-type: none"> • In addition to aforementioned consequences: <ul style="list-style-type: none"> ○ Regulator automatically authorised to take control of the insurer. ○ Regulator has discretion on measures, e.g. continued pursuance of (revised) RBC plan, rehabilitation, liquidation, etc.
< 70%	Mandatory Control Level	<ul style="list-style-type: none"> • Regulator to take insurer under control.

⁴³ USC: Title 12, 1831o, Prompt Corrective Action.

⁴⁴ Source: National Association of Insurance Commissioners; in: The Geneva Association (2012). *Insurance and Resolution in Light of the Systemic Risk Debate*.

ANNEX II

Insurance risk-based capital categories

Risk-Based Capital Background

Risk-Based Capital came into existence as result of several insurer insolvencies in the U.S. in the late 1980s and 1990s. These events influenced regulators to create Risk-based Capital requirements that rely on the assessments of investments, pricing and underwriting risks. Higher risk of an investment portfolio or underwriting comes with higher required capital.⁴⁵ The following activities are included in the RBC calculation:

1. *Asset Risk – Affiliates*: This is the risk of assets` default for certain affiliated investments
2. *Asset Risk – Other*: This is the risk of assets` default of principal and interest or fluctuation in fair value.
3. *Insurance Risk*: This is the risk of underestimating liabilities from business already written or inadequately pricing business to be written in the coming year.
4. *Interest Rate Risk, Health Credit Risk, and Market Risk*: This is the risk of losses due to changes in interest rate levels and the risk that health benefits prepaid to providers become the obligation of the health insurer once again, and risk of losses due to changes in market levels associated with variable products with guarantees.
5. *Business Risk*: This is the risk of general business.

Activity risk weights⁴⁶

Bonds

“The bond factors are based on cash flow modelling using historically adjusted default rates for each bond category”. This risk category assigns capital weighting to different types of bonds are all weighted in a different way, based on whether they are long and short term.

Mortgage Experience Adjustment

“...the formula includes a moving eight quarter average ratio of company to industry experience with minimum and maximum limits. This experience adjustment is defined and calculated to be consistent with the adjustment that is used to calculate the asset valuation reserve”.

Mortgages

Mortgages are divided in different groups, based on for what sort of object the mortgage is used for (farm, residential or commercial), where per category a further distinction takes place on the basis of whether or not the loan is insured or otherwise guaranteed.

Unaffiliated preferred and common stock

In this category the distinction is made between Unaffiliated Preferred Stock and Unaffiliated Preferred Stock. As per the end of the year 2004 the RBC factors for Unaffiliated Preferred Stock are the same as for bonds, ranging from 0.4 to 30 per cent. In the Unaffiliated Common Stock the assigned weightings range from 0.4 to 30 per cent.

Separate Accounts

There are indexed and non-indexed guaranteed separate accounts and non-guaranteed separate accounts. The capital surcharge for non-guaranteed accounts varies from 2.4 to 11 per cent.

⁴⁵ Skipper & Kwon, 2007, *Risk Management and Insurance; Perspective in a Global Economy*.

⁴⁶ NAIC, 2010. Risk-Based Capital Life, forecasting & Instructions, there are also requirements specific to non-life activities, see NAIC.

Real Estate

Capital weightings in this category vary from 15 to 23 per cent.

Other Long-Term Assets

“Recognizing the diverse nature of Schedule BA assets, the RBC is calculated by assigning different risk factors according to the different type of assets. Assets with underlying characteristics of bonds and preferred stocks rated by the NAIC Securities Valuation Office (SVO) have different factors according to the SVO assigned classification. Unrated fixed-income securities will be treated the same as Other Schedule BA Assets and assessed a 30 per cent pre-tax charge. Rated surplus and capital notes have the same factors applied as Schedule BA assets with the characteristics of preferred stock. Where it is not possible to determine the RBC classification of an asset, a 30 per cent pre-tax factor is applied”.

Schedule BA Mortgages

The weighting factors used for this category are the same as for commercial mortgages.

Asset Concentration Factor

The Asset Concentration Factor is meant to reflect the added risk of high concentrations in single exposures (i.e. holding many shares or bonds represented by the same individual issuer). Factor is a surcharge on top of the existing weightings for the previous categories (i.e. Bonds, Mortgages etc.) and varies from 0.4 to 22 per cent.

Common Stock Concentration Factor

The purpose of the Common Stock Concentration Factor is similar to that of the Asset Concentration Factor. “The common stock concentration factor increases by 50 per cent the risk-based capital factor for the five largest common stock exposures”.

Miscellaneous Assets

Weightings for this category range from 0.4 per cent for *cash* to 30 per cent for *over the counter class 6 derivative instruments*.

Replication (synthetic asset) Transactions and Mandatory Convertible Securities

“A replication (synthetic asset) transaction is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments”.

Reinsurance

The risk related to recoverability of amounts from reinsurers is seen as similar to the risk represented by bonds in the risk classes 1 and two and therefore assigned a risk factor of 0.08.

Off-Balance Sheet and Other Items

The potential risks which come with off-balance sheet items are weighted with a ratio between 1.3 per cent for non-derivative items up to 30 per cent for derivatives.

Off-Balance Sheet Collateral

“Security lending programs are required to maintain collateral”. The weightings for the several forms of off-balance sheet collateral range from 0.4 per cent for the *fixed income bonds Asset Class 1* up to 45 per cent for *Common Stock*.

Health Premiums and Health Claims Reserves

Health Premiums are divided into the following subcategories which have their own risk-based capital factors assigned to them. The following distinctions are made: medical and disability

income, long-term care insurance and other types of health insurance premiums and the capital ratios go up to 35 per cent.

Underwriting Risk – Experience Fluctuation Risk

“The underwriting risk generates the RBC requirement for the risk of fluctuations in underwriting experience” “...Underwriting risk is present when the next dollar of unexpected claims payments comes directly out of the company’s capital and surplus. It represents the risk that the portion of premiums intended to cover an insured expense, will be insufficient”. The calculation of the RBC ratio for this category of underwriting risk is amongst others based on the underwriting risk revenue, insured claims and risk claims ratio. A detailed overview can be found on the table on page LR018 of the NAIC Risk Based Capital manual.

Underwriting Risk – Other

“In addition to the general risks of fluctuation in the claims experience, there is an additional risk generated when insurers guarantee rates for extended periods beyond one year. If rate guarantees are extended between 15 and 36 months from policy inception, a factor of 0.024 is applied against the direct premiums earned for those guaranteed policies. Where a rate guaranty extends beyond 36 months, the factor is increased to 0.064”.

Long-Term Care

“The long-term care morbidity risk is calculated in part based on the current year’s earned premium”. A distinction is made between premiums not exceeding USD 50 million and premiums exceeding USD 50 million.

Life Insurance

“The factors chosen represent surplus needed to provide for excess claims over expected, both from random fluctuations and from inaccurate pricing for future levels of claims”. There are three different ratios, based on portfolios of 10,000, 100,000, and one million lives. The ratio is lower, the higher the number of insured cases in the portfolio, the lower the ratio (in line with the law of large numbers) and varies from 0.8 to 2.3 per cent.

Premium Stabilization Reserves

“Premium stabilization reserves are funds held by the company in order to stabilize the premium a group policyholder must pay from year to year. For group life and health insurance, 50 per cent of premium stabilization reserves held in the annual statement as a liability (not as appropriated surplus) are permitted as an offset up to the amount of risk-based capital”.

Interest Rate Risk and Market Risk

This is the risk of losses as a result of interest rate levels.

Health Credit Risk

“The Health Credit Risk is an offset to some portions of the managed care discount factor”. The Health Credit Risk compares the capitation payments in order to transfer health risks to health care providers, done via fixed prepaid amounts, to security the company holds. In case the security does not completely cover the risk of capitated payments a risk charge is applied, varying from 2 to 4 per cent.

ANNEX III

Impaired insurers case studies

- *HIH Failure in Australia in Light of the Systemic Risk Debates*

Early in 2001, one of Australia's largest insurers was placed into provisional liquidation. The Royal Commission appointed to investigate the circumstances of HIH's wind down reported that despite the numerous consequences throughout society, there was no systemic risk. HIH, which started as an insurer who provided workers compensation cover in the state of Victoria expanded rapidly in the 1980s and 1990s, mainly by acquiring other non-life firms in Australia and abroad. The Royal Commission attributed the following factors to the failure of HIH: absence of a clear group strategy; competing and underpricing of risk in a hard and competitive market, leading to under-reserving HIH was competing heavily with the other players in the market, but that eventually undermined its own position, because it did not price the risks to their market value. HIH was growing, and because of its size, it should have been subject to more intense supervision, but this did not happen due to reorganizations at the supervisor⁴⁷.

- *The Ethias Case*

The Ethias failure is been seen as insurance "run" - however this is a misconception. "Insurers align their investment activities very closely with expected pay-out patterns and do not face the asset-liability mismatch and instability of fractional-reserve banking which is inherent to deposit-taking institutions. Insurers are not affected in the same way by liquidity risks as other financial institutions. They generally do not rely on short-term market funding and, therefore, are not subjected to the kind of liquidity risk affecting banks. They receive premiums up-front and pay out claims later. In general, pay-outs do not depend on the will of the policy-holder but are driven by fortuitous events such as death disability or a natural disaster. An exception is life insurance where, however, most companies impose high cancellation fees which discourage early redemption. In addition, the case of the Belgian insurer Ethias does not lend itself to exemplify an insurance "run". The redemptions the Company suffered occurred in one specific segment of its products universe only, `life insurance` products which, as a matter of fact, were bank savings deposits, redeemable at any time, at no penalty" For further details on the Ethias case, see the 2010 report. ⁴⁸

- *AIG Financial Products*

In the case of AIG it is important to stress that the holding company (of which AIG Financial Products was part) was not an insurance firm but a financial conglomerate, detached from the core insurance business, regulated and supervised by the Office of Thrift Supervision.

The AIG's issues were caused by a mix of the following factors:

- Inside factors, reliance on the strength of the AIG insurance operations to obtain a high credit rating for innovation in financial products outside of the insurance operations; CDSs contract design; and financial models that did not anticipate the liquidity crisis.
- External Macro Factors- lax thrifts and banking regulation with no regulation of derivatives (free markets ideology); housing market bubble and collapse (entitlement to homes ideology); securitisation growth; reliance on credit ratings agencies; and a liquidity crunch in September 2008 that prevented AIG and other from accessing the capital markets.

⁴⁷ See Baranoff (2011): Systemic Risk Versus the 10-year Old Insurance Failure in Australia. And also Wilkins, M. (2011): HIH Systemic Risk or Opportunity?

⁴⁸ The Geneva Association (2010), *Key Financial Stability Issue in Insurance; An account of The Geneva Association's on-going dialogue on systemic risk with regulators and policy-makers*. Pp.16.

- All factors came to a head to bring about the collapse: no regulation of sophisticated financial products with high credit ratings → growth in CDSs → models not predicting housing markets' collapse and rating downgrades → calls for cash collaterals → liquidity crisis → taxpayer bailout.

For details on the AIG case, please see The Geneva Associations April 2011 report⁴⁹

- *Insurance runs in Singapore and Hong Kong*⁵⁰

- In Hong Kong, the news of the difficulties experienced by AIG led to a higher number of surrendered policies by American International Insurance Company (Bermuda) Ltd and American, in the first days after the news became known. The Insurance Authority of Hong Kong imposed a ring-fencing measure, this had a stabilizing effect, and as a result, the number of surrendered policies dropped, and remained stable throughout the 2009, after September, the level was similar to that prior to the crisis.
- The news of the financial difficulties at AIG in the US led also to loss of confidence amongst customers of AIG's subsidiary (AIAS) in Singapore and as a result, many customers started queuing at the Customer Service Centres. But the number of surrenders as percentage of total insurance policies was still relatively small so AIAS did not face any liquidity constraints. The Monetary Authority of Singapore (MAS) issues press releases in the weeks following the AIG event in the US, to assure clients that AIAS was meeting the regulatory capital requirements and its funds are segregated from its Head Office. MAS further imposed asset 'ring fencing' measures on AIAS.

- *State intervention in the Netherlands*

- During the height of the financial crisis in 2008, the Dutch government provided capital support to three financial institutions, ING Group, Aegon and SNS Reaal. These institutions together received around EUR 14 Billion in total. What these three financial institutions have in common is that they all provide banking services. ING group for example, consist of a large bank with a balance sheet total of EUR 1000 billion, its insurance business is much smaller, with a balance sheet of around EUR 300 million. Aegon on the other hand has a much larger insurance business (EUR 290 billion) and a relatively small banking part (EUR 5 billion). The banking and insurance business of SNS Reaal are more symmetric with a banking balance sheet of EUR 75 billion and an insurance division of EUR 50 billion. Despite the different details, there are a few similarities to these three cases. First of all, these institutions faced acute liquidity problems as money markets dried up due to the financial crisis and the subsequent lack of confidence amongst financial institutions. Especially the banking parts of these firms were hard hit as they are very vulnerable to an unexpected withdrawal of deposits. The insurance divisions are much less vulnerable to liquidity problems, as a result to the long-term character of their liabilities. Another common element is the loss of confidence and decreasing reputation of the financial sector as a whole. Within financial conglomerates as these three organizations "confidence effects may cause distress at the insurer to spread to the bank or vice versa, regardless of the level of actual financial linkages between the bank and insurer"⁵¹

⁴⁹ The Geneva Association (2011). Considerations for Identifying Systemically Important Financial Institutions in Insurance.

⁵⁰ IAIS (2011). Insurance and Financial Stability.

⁵¹ IAIS (2011) Insurance and Financial Stability report. pp. 39.

- *General American Life Insurance company*
 - In August 1999 General American Life Insurance experience liquidity shortage, when the demand for cash “under funding agreements with unconditional/unrestricted `7 day put` provisions, exceeded the amount that could be raised quickly”. This liquidity crisis was partly triggered by a downgrade, but another contributing factor was that there was large funding agreement contracts held by a relatively small number of customers. The 7 day put option made that the cash out flows had short term horizons.⁵²

⁵² American Academy of Actuaries (2000), Report on the Life Liquidity Work Group of the American Academy of Actuaries to the NAIC’s Life Liquidity Working Group.

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