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Federal Regulation: An Update

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Agenda

- Systemic Risk Regulation: American Academy of Actuaries Public Policy Recommendations
- Federal Insurance Office: An Update

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Systemic Risk Regulation



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The Regulation of Systemic Risk

Public Policy Recommendations



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Academy Recommendations Regarding Systemic Risk Regulation

A systemic risk regulatory structure for the financial services industry that:

- Establishes limits on corporate actions that may create systemic risk
- Works in concert with functional regulation to assess the ability of companies to evaluate and manage their risks and to implement any of the actions needed to limit systemic risks
- Assures that rating agencies and other third party advisors provide adequate transparency about their assumptions, methodologies, and recommendations.



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Systemic Risk Regulation

It is important that systemic risk nation-wide be monitored and evaluated at the national level, but also include an awareness of local and global influences and trends:

- Key goals for the effective regulation of systemic risk include:
 - Identification of systemic risk
 - Measurement and monitoring of systemic risk
 - Management of systemic risk
- Key steps to implement successful systemic risk regulation include :
 - Collection of the right data
 - Development of meaningful and actionable metrics
 - Inclusion of functional regulators and non-governmental bodies and defining effective SRR roles for them



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Systemic Risk for Insurance

- Investment Risk
 - Similar to risks of banks
- Catastrophes
 - e.g. Multiple hurricanes in one area
 - Need to avoid over exposure in any one area or to any single type of risk
- Mortality/morbidity
 - Annuity and Life insurance mortality don't always offset
 - Not the same people
 - Annuities tend to be for older people
 - Not as much annuity mortality risk in force but growing
- Need to be particularly careful about reinsurers since they serve as risk mitigators
 - Much of their business deals with catastrophic or other tail events



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Limitations to Avoid or Manage Systemic Risk

- The determination of an adequate level of capital for companies that provide any significant form of financial guarantees.
- The establishment of minimum capital requirements for companies where significant investments are exposed to systemic risk, e.g., derivatives.
- The regulation of risky investments by financial services companies where:
 - High volatility of results is expected and/or
 - The availability of information is limited making expectation of future returns speculative
- These regulations also should apply to new products that seek to manage insurance risks.



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Essential Elements of a Risk-Based Regulatory System

- A risk-based regulatory environment should include:
 - Principle-based regulation that focuses on the risks unique to each company as well as the markets they affect.
 - Limitations to protect the public from the adverse financial consequences of risk and uncertainty under a principle-based system, e.g., especially where there is a lack of information to quantify risk there is a need to understand the limitations of the models and assumptions.
 - Quantitative risk measures to identify a minimum level of acceptable financial strength across the industry.
 - Qualitative measures intended to evaluate the effective financial and risk management of companies and their ability to take action when appropriate.
- Risk management is most effective when used to prevent crises rather than manage them
- Systemic risk regulation should complement functional regulation and involve the professionals who are skilled at evaluating various risks
- The increasing complexity of the asset and liability risks of financial institutions makes it critical to have:
 - appropriately qualified professionals, such as actuaries, within the company and at the regulatory level



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Requirements for Rating Agencies and Other Third Party Advisors

- The financial services industry and its regulators rely upon the expertise of third party advisors, e.g., credit rating agencies.
- For new asset classes or businesses with little historical experience and potentially unknown volatility, the reliance on such advisors, and the limitations of their expertise, should be considered.
- Rating agencies and third party advisors should be required, or at least be held accountable, to provide substantive transparency as to the supporting data and methodologies underlying their conclusions, and to their limitations.
- Based on the information provided, the company and regulators can choose among advisors for the best information upon which to reach a decision.
- Accountability for conclusions reached rests with the user of information from third parties.



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Constraints and Capital Requirements on Investments

- Insurance regulation has served the public well in recognizing the need to constrain investments in certain investment classes, i.e., limitation on derivatives for investment rather than hedging purposes.
- Financial services companies that issue guarantees should have a primary investment objective to manage their asset/liability risk in a prudent manner.
 - Investments such as derivatives have a place in this activity when used to manage risk rather than create risk.
 - There is a role for “riskier” investments designed to improve return on investments of the company capital
 - Regulation should address appropriate controls where investments are subject to high volatility, limited available information, or speculative returns, especially where systemic risk factors are in play.



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Federal Insurance Office



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Federal Insurance Office: Kanjorski Amendment (HR 2609)

- Monitor all aspects of the insurance industry that
 - identify issues or gaps in regulation contributing to systemic risk
- Coordinate federal efforts and establish federal policies on the prudential aspects of international insurance matters
- Recommend insurer subject to heightened regulation
- Consult with states
 - Matters of national importance
 - Prudential matters of international insurance
- Assist Secretary in administration of TRIA
- Determine whether state insurance measures are pre-empted by international insurance agreements

Office in Department of Treasury

Federal Insurance Office: Current Provisions

Does not provide for Office of Federal Chief Actuary

- Federal Office of Actuary is critical:
 - Formation of infrastructure of FIO
 - Establishment of ongoing operations of the FIO
- Current recognition of value of actuary at the federal level
 - Social Security
 - Medicare
- Actuarial expertise
 - Identify and evaluate current and future risk
 - Identify data required to monitor and analyze risk
 - Identify data sources and design the tools to accumulate and analyze data
 - Develop and implement methodologies to quantify risk and communicate findings
- Actuaries deal with risk unique to insurance industry and financial service centric risks



Q&A



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