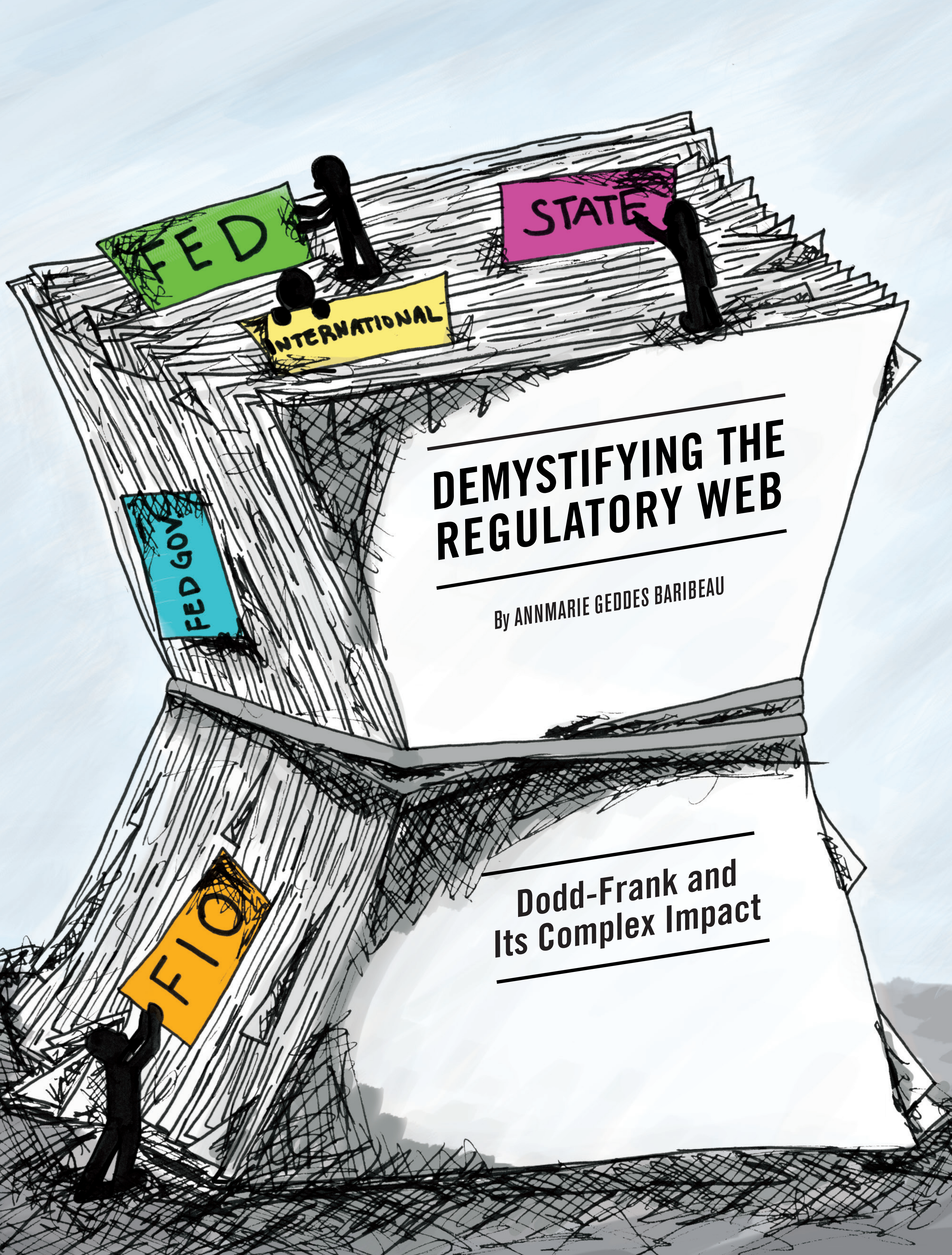

DEMYSTIFYING THE REGULATORY WEB

By ANNMARIE GEDDES BARIBEAU

Dodd-Frank and Its Complex Impact

By inserting federal roles between state regulators and international groups, the impact of the Dodd-Frank Act remains unsettling.

Nearly six years ago, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 into law. As the nation's most expansive federal reach into the traditionally state-regulated insurance industry, Dodd-Frank's impact on property-casualty insurers and the actuaries who serve them continues to unfold.

At first glance, the law sponsored by Sen. Chris Dodd (D-Conn.) and Rep. Barney Frank (D-Mass.) appears to affect a limited number of insurers and their actuaries. There are signs, however, that Dodd-Frank's impact could gradually spread throughout the insurance industry.

The law granted limited regulatory authority to the Federal Reserve System (Fed) and directed the formation of the U.S. Treasury's Federal Insurance Office (FIO) to monitor the industry. By introducing unprecedented insurance federal regulation and policy influence, Dodd-Frank creates a web of ramifications to untangle.

Part of this includes Dodd-Frank authorizing the Fed and the FIO to act on the international insurance policymaking stage. This allows both organizations to influence — and be influenced by— the International Association of Insurance Supervisors (IAIS), where issues were already being largely addressed by state regulators through the National Association of Insurance Commissioners (NAIC).

"Despite its proven track record, the domestic regulatory landscape is being forced into significant changes," stated Rep. Blaine Luetkemeyer (R-Mo.), chairman of the House Financial Services' Housing and Insurance Subcommittee, at the subcommittee's hearing on September 29, 2015, according to an unofficial transcript provided to *Actuarial Review*.

"Today, we see more intrusion in insurance by not only the federal government, but also international financial regulators. Dodd-Frank has allowed that to happen, the integration of the Federal Insurance Office and the powers granted to the Federal Reserve Board of Governors," he noted.

And since the law left many regulatory decisions up to the Fed — an agency that did not historically regulate insurance — rule promulgation for the

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insurers it regulates remains a work in progress. Meanwhile, both state regulators and the Fed continue to address similar concerns, such as solvency, on separate tracks with differing approaches, necessitating future harmonization to avoid overlap while both are responding to international pressures.

When the Fed finishes its rules and the IAIS completes its standards, actuaries will be key in addressing the "whole financial element" of these new standards, said David F. Snyder, vice president of international policy for the Property Casualty Insurers Association of America (PCI).

The affected actuaries, said Jim MacGinnitie, senior property-casualty fellow at the American Academy of Actuaries, will likely need to adapt and adjust loss reserving calculations and financial risk management processes.

At the same time, Congress, which monitors the progress of Dodd-Frank and has already passed legislation to adjust it, is considering even more changes.

Genesis

Sweeping acts of the U.S. Congress generally occur in response to a significant national problem — and the Dodd-Frank Act is no exception. "The Dodd-Frank Act was a creature of the 2008 financial crisis," said Robert Hartwig, president of the Insurance Information Institute (III).

At its core, offered John Huff, president of the NAIC and Missouri's insurance commissioner, "The financial crisis was a banking crisis, and the insurance industry generally weathered the storm." So it's unsurprising that Dodd-Frank's inclusion of insurers, and the resulting regulatory burden, remains a point of frustration.

"If we fast forward 10 to 20 years after Dodd-Frank," Hartwig opined, "many of its designers could say the focus on banks was appropriate but will recognize in time that including insurers was not." Instead, he added, "They will probably wish they had included other financial entities such as large hedge funds or other areas where economic risks are building."

Insurers were primarily included in the law, Hartwig said, because the American Insurance Group's (AIG) financial products division, a banking function unrelated to its insurance operations, contributed to the crisis. "AIG is repeatedly used," PCI's Snyder said, "as the main justification for a very broad interpretation of the limited additional authority that was given to the U.S. Treasury's FIO and Fed under Dodd-Frank."

Huff points out that when the financial crisis started, AIG's financial products division was already under federal regulation by the U.S. Treasury's Office of Thrift Supervision (OTS). "The state-regulated insurance subsidiaries were stable and eventually enabled the U.S government to profit on its cash infusion into the company," he added.

Federal Reserve Authority

The United States Constitution's commerce clause gives Congress authority to regulate interstate commerce, which can include insurance. However, for about 150 years, Congress has yielded regulatory authority to the states. With the War Between the States fresh in its memory, the U.S. Supreme Court concluded in 1868 that since insurance was not commerce, Congress did not have the authority to regulate it.

Seventy-six years later, the highest court of the land then recognized insurance as interstate commerce. Nonetheless, the next year Congress passed the McCarran-Ferguson Act of 1945 to preserve states' authority to regulate and tax insurers.

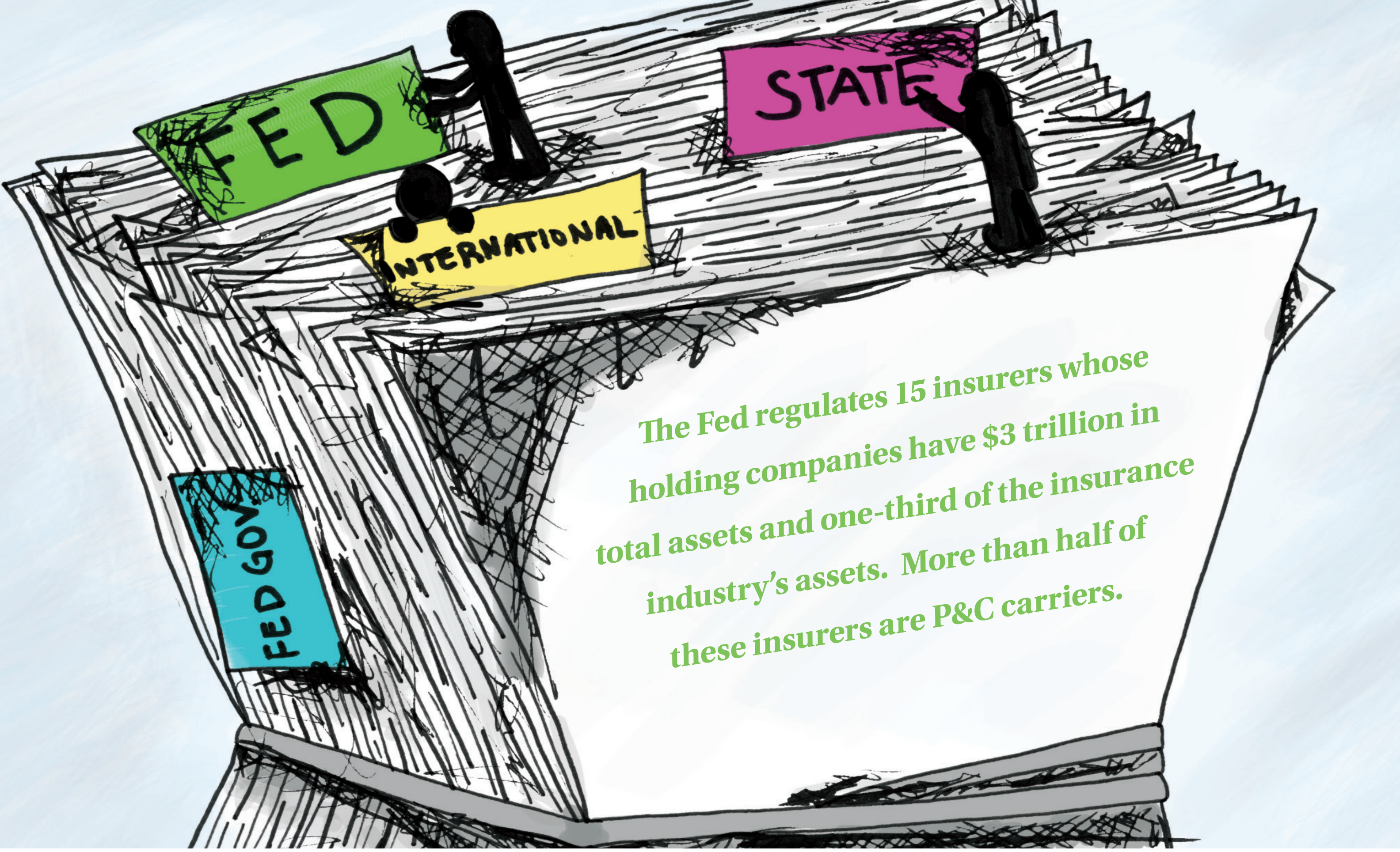
Dodd-Frank's focus on preventing systemic risk in the U.S. economy granted the Fed authority to regulate two types of insurance companies. One group consists of insurers considered to be systemically important financial institutions (SIFIs). The Fed's regulatory responsibility also includes insurance holding companies that have banks or thrifts.

The Financial Stability Oversight Council (FSOC), under the auspices of the U.S. Treasury, assigns a SIFI designation to financial institutions, including insurers, which could cause a national systemic economic disruption if they fail.

Of the three designated insurers, two offer property-casualty insurance —AIG and MetLife — while Prudential is a life insurance company.

The very notion of insurers being designated as SIFIs remains controversial. That's no surprise given the burden of additional regulation, the difference in business models between insurers and banks, and acknowledgement that insurers in general made a minimal contribution to the Great Recession. Further, the process of determining what makes a business a SIFI is "nebulous," Hartwig said. "Neither FSOC nor the Fed have provided a prescription that, if followed, allows insurers to stay off or get off the list," Hartwig maintained.

Roy Woodall, FSOC's independent member with insurance expertise, told the congressional subcommittee last fall



that two insurers (AIG and Prudential) were deemed international SIFIs before FSOC designated them as national SIFIs. "And I really feel like that we've got a situation where the international people have been driving that car," Woodall added.

Woodall also noted in his written testimony that he did not agree with FSOC's decision to designate MetLife and Prudential as SIFIs. MetLife is disputing FSOC's SIFI designation, so that could change.

The Fed also holds regulatory responsibility for insurance holding companies with banks or thrifts. At press time, the Fed regulates 15 insurers whose holding companies have $3 trillion in total assets and one-third of the insurance industry's assets.

More than half of these insurers are P&C carriers. According to a list provided by the Fed, these include State Farm Insurance, Nationwide Mutual Insurance Group, USAA, Auto Club Group, First American Financial Corp., Ohio Farmers Insurance Co., Illinois Farm Bureau and Donegal Insurance Co.

Other insurers, including Northwestern Mutual Life Insurance Co., Prudential Financial, Massachusetts Mutual Financial Group and W.R. Berkley Corp. have either reduced their thrifts to trust banks or divested their thrifts to avoid Fed regulations, according to the 2013 article, "W.R. Berkley Sells Interest in InsurBanc to a Bank He Chairs," at propertycasualty360.com.

The Fed has about 90 full-time equivalent employees supervising these insurers, said Thomas Sullivan, associate director of the Fed's division of banking supervision and regulation, at last September's congressional hearing.

The Fed monitors these insurers through day-to-day supervision to protect consolidated firms' safety and soundness and mitigate financial stability risks, added Sullivan, a former Connecticut state insurance commissioner. Fed supervision, he told the subcommittee, means working with insurers to strengthen their measurement and management of internal controls, corporate governance, and risk identification.

In summary, Fed oversight à la Dodd-Frank means that Fed-regulated insurers must:

- Develop living wills (also known as resolution plans) to be used in the case of bankruptcy.
- Meet liquidity requirements.
- Undergo stress testing.
- Adhere to capital standards.

So far, the Fed has developed standards on living wills and qualitative liquidity requirements, but there is still much work to be done. Quantitative liquidity requirement regulations have not been set. Stress testing will depend on first finishing capital requirement regulations, according to the Fed.

Since the Dodd-Frank Act became law, insurers have been very concerned that they will have to abide by banking-influenced regulations when their business models are different. The Insurance Capital Standards Clarification Act of 2014, supported by the Fed, answered some of that concern. It removed the Dodd-Frank mandate that Fed-regulated insurers must maintain the same capital standards as banks.

The Fed continues to build its "domestic regulatory capital framework" so it is well tailored to "specific business lines, risk profiles and systemic footprints," Sullivan told the congressional subcommittee.

"The Fed has not yet promulgated the capital standards, and Congress has been after them to move that forward," MacGinnitie said.

During the congressional hearing, Sullivan could not say when domestic capital standards would be ready because the Fed is not being driven by an "artificial timeline." "I don't think this is something we want to hurry or rush along," he said. "I think this is something we want to be very careful and thoughtful and deliberate about."

Of the year 2016, Snyder predicted that it "will be a busy year for developing these standards."

The Fed continues to consider how insurance holding company standards will affect state-based regulation or regulatory initiatives.

While the Fed expresses commitment to working with state insurance commissioners and the NAIC, there is also concern that the Fed is being too sensitive to international interests. "It's imperative that the Fed develop domestic standards first, then export it to the rest of the world," Rep. Luetkemeyer said.

When it comes to understanding the insurance industry, the Fed and FSOC are facing a learning curve. As a new insurance regulator, "The Fed is interested in how the SIFIs, in particular AIG, put their financial statements together," MacGinnitie explained. The Fed also wants to understand the reserving process and how actuarial judgment comes into play, he said.

At the invitation of FSOC's insurance representative, the American Academy of Actuaries has been providing FSOC's insurance industry work group with information about actuaries' role in promoting financial stability and the regulatory capital requirements for U.S. insurers. In December 2015, Academy representatives made two presentations to the work group, one focused on risk-based capital and the U.S. solvency framework, and the other focused on actuarial professionalism and the prominent role that the U.S. actuarial profession plays in ensuring the solvency and stability of domestic financial systems.

Explaining actuarial judgment, and demonstrating that it can be trusted, is perhaps the largest challenge. "It looks like a black box to an outsider, and I think it is fair to say there is

a distrust in black boxes because of the banking experience," MacGinnitie offered.

Since there is a high probability that regulators and insurers regulated by the Fed will want an even playing field, Snyder believes more insurers will see directives increase in the future. "CEO-level executives are understanding this dynamic," Snyder added.

Federal Insurance Office

The FIO serves several functions. To provide insurance information in one place, it assembles insurance data from various organizations including the III and the NAIC. If the FIO desires not-already-collected information, it has the power of subpoena, if necessary, to gather it directly from insurers. "The view was the federal government needed to have its own resource with respect to the insurance industry and previously it had none," Hartwig said.

The agency also monitors the insurance industry in various ways. It identifies insurance activities that could contribute to a broader U.S. financial systemic crisis, develops federal policy regarding nationally or internationally important insurance issues, and consults with state governments on insurance matters. Since its monitoring authority is so broad, Snyder pointed out, the FIO "can monitor almost anything they want and make recommendations."

One specific Dodd-Frank mandate is for the FIO is to monitor the affordability and availability of insurance, with the exception of health care coverage. "My impression is that the net is fairly wide here," MacGinnitie said.

The agency is currently focusing on automobile insurance affordability and availability. It published two requests in the Federal Register to gain industry insight on how to measure affordability and identify appropriate data for this purpose, Snyder said.

Says Hartwig, "The FIO wants to come up with an objective measure, but any such measure will be inherently arbitrary." For example, one approach under consideration is to define auto insurance as affordable if it accounts for two percent or less of a person's income, he added.

Snyder offered that the PCI approach to affordability is that it should be the function of how much a person has to pay for car insurance after essentials such as food and housing are covered. "With this approach, we believe auto insurance is affordable for everyone," he said.

Insurance commissioners, however, are already sensitive to affordability, availability and rating issues, MacGinnitie said. Such issues came up with credit scoring more than a decade ago and now with pricing optimization (see "Pricing Optimization and the Descending Confusion," *AR* September/October 2015.).

Regardless, MacGinnitie believes that the insurance industry will adapt as it did when the U.S. Supreme Court upheld a nontraditional definition of marriage. He expects more public dialogue about this in the future since Insurance Services Office Ltd. data show that auto insurance claim frequency and severity are increasing. This will probably lead to higher prices and perhaps draw more attention to affordability, availability and rating practices.

In the section on underwriting fairness in FIO's 2015 annual report, the office encourages states to reconsider gender as a factor for rating and underwriting, which can also complicate auto insurance applications for transgender individuals. Further, the FIO also encourages states to reconsider the marriage factor in premiums, which might not be fair to unmarried persons.

Another FIO responsibility is to work with the U.S. Trade Representative to negotiate covered agreements with foreign regulators that could alter state law, Snyder stated. For example, he pointed out that the FIO is developing a covered agreement for reinsurers and insurers in the U.S. to ensure that the country's requirements are deemed equivalent to those in the European Union (EU). The goal is to ensure that American companies are treated equally in the market and to address the EU's concerns regarding reinsurance collateral.

"This is the one area where the FIO has regulatory authority and can actually preempt state laws," Snyder emphasized. It is also an example of where the federal government is moving on a parallel track with state insurance regulators towards the same goal.

The NAIC has already been changing relevant provisions of its Credit for Reinsurance Model Regulation, which would reduce insurance collateral for reinsurers with a solid financial statement domiciled in a country with a solid regulatory environment, Snyder said.

At the congressional subcommittee hearing, Huff of the NAIC expressed concern that FIO could "unnecessarily" preempt state laws and insurance commissioners' progress on reinsurance reforms.

"We question whether a covered agreement or any formal

Top Actuarial Concerns from Dodd-Frank

The Dodd-Frank Act will affect actuaries in several ways, according to the SimErgy Consulting report, "Regulatory Risk and North American Insurance Organizations: A Company Perspective." The Casualty Actuarial Society, Canadian Institute of Actuaries and the Society of Actuaries sponsored the report, which was issued in February 2015. In the table below, Jim MacGinnitie, senior property-casualty fellow at the American Academy of Actuaries, identifies some of the most significant effects that Dodd-Frank will have upon P&C actuaries, based on the report.

Excerpt of "Appendix B: U.S. Research Study — Key Regulatory-Related Risks — Ranked by P&C Score"*

Theme	Risk Scenario	Average Likelihood (Over the next three years)†	Average P&C Severity (Loss in P&C Business Value)‡
Dual Regulation	Dual regulation (at state and federal level) results in new accounting and solvency standards emerging that create an inconsistent and non-level playing field in the insurance market.	6.5%	3.1%
Dual Regulation	Insurance industry becomes subject to a federal regulatory body (e.g., Securities and Exchange Commission) in addition to state regulation, resulting in regulations that are overly restrictive and more expensive to comply with.	4.8%	4.2%
Increase in Capital Requirements	Capital requirements (either issued by the International Association of Insurance Supervisors (IAIS), Federal Insurance Office, or other entity) increase by 20 percent.	3.1%	4.9%
Standardization Requirements Drive Commoditization	Federal Insurance Office unexpectedly succeeds in pressuring states to adopt standardized property-casualty forms, rate classifications or rates, commoditizing products and reducing competitive advantages and profit margins.	1.8%	7.8%
Dodd-Frank Regulation of Banks	Dodd-Frank further expands regulations on banks, resulting in significant increase to compliance costs for insurers that have banks within their organizational structure.	9.9%	1.8%

* https://www.casact.org/cms/pdf/NAAC_Reg_Risk_Research-FINAL.pdf
† As of February 2015
‡ The loss to the portion of company value attributable to the P&C business, which includes auto, homeowners, etc.

action by the federal government is necessary to resolve equivalence as it is clear that recognition can be achieved through other mechanisms," he said, adding that he expects the FIO to work with state insurance commissioners "to ensure our state regulatory system is not compromised."

International Concerns

Balancing United States insurer and consumer interests with international concerns, which was once funneled purely through state regulators through the NAIC, now has two additional intermediaries.

Dodd-Frank in essence sets up the conditions whereby the Fed and the FIO can be part of the international insurance standard-setting process by participating at the IAIS as the NAIC historically has. Federal representation introduces nuances that can affect how insurance regulations will look for insurers in the United States.

The Fed, FIO and NAIC — called "Team U.S.A." —have different missions and goals, which sometimes causes a collision of regulatory and policy approaches, sources say.

Since the Fed is deeply involved in international banking standards, Snyder sees the need to make sure it does not apply international banking concepts that might not be good for the insurers the Fed regulates.

The FIO has nary a regulatory role, but its impact on national and international regulation continues to grow. While FIO's regulatory power in ensuring U.S. insurers have international equivalence is a very limited de jure role, FIO's expansion in the policy arena is giving the agency a greater de facto power that goes beyond what most people thought the Congress intended in Dodd-Frank, Snyder explained.

The implications signal more than a mere turf battle, but could slowly shift the nation's state regulatory foundation and traditional international role.

Advocates in favor of federal regulation point to greater consistency in domestic and international standards. However, federal processes have not shown themselves to be as transparent as those of state insurance regulators, Snyder emphasized.

For example, the FIO is not adopting the NAIC's traditional transparent and open public approach to regulation, Snyder stressed. This transparency is intended to ensure protection of consumers and insurers. Instead, the FIO voted for closed-door procedures and eliminated observer participation in working groups, he added. "So you have a clash of regulatory culture, the one being closed door and the other being more open," Snyder added.

At the same time, the international community is pressuring the U.S. to grow its regulatory role due to deficiencies it sees in the state-based regulatory approach. "International banking bodies, such as the International Monetary Fund, advocate more centralized authority at the United States, which would give the federal government more regulatory power," Snyder explained.

The Treasury often advocates for more federal insurance regulatory authority by identifying opportunities for it, Snyder said. The news release announcing its 2013 report, "How to Modernize and Improve the System of Insurance Regulation in the United States," said that the report recommends a "hybrid" model for insurance regulation.

If the resulting international standards do not reflect current state-based regulation, Snyder speculated that there could be less product innovation, higher costs and fewer options for consumers. "The European top-down approach to regulation, if adopted here, could force insurers to consolidate, leaving fewer insurance options and ironically, creating larger insurers that could become systemically important," he said.

State regulators face higher accountability because they are elected or appointed by the state governor, Snyder said. "More accountable state regulation did much better," he maintained. Federal regulators are accountable to Congress, he said, but oversight has been challenging.

Conclusion

Assuring solvency is one of the most important roles actuaries play in the insurance industry. Since Dodd-Frank gave federal agencies regulatory and policy influence, actuaries have a greater role to play in educating federal officials. How state and federal regulations — along with international standards —will look is unclear, but property-casualty actuaries should keep up with state, federal and international activity to prepare for the future.

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