The Property Casualty Insurance Guaranty Funds and the NCIGF:
Keeping the Insurance Promise for 25 Years.

Federal and International Insurance Issues

Their Potential Impact on State-Based Guaranty Funds, the Policyholders They Protect and What Comes Next

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National Conference of Insurance Guaranty Funds NCIGF

Why Should We Care?

"The changes underway will alter the basis for much of your work in ways that are not yet clear."

William P. White, former Commissioner,
DC Department of Banking and Insurance

October, 2013

State of Play, Post-2008

The federal government and international authorities now subject the insurance industry to macro-prudential regulation, intended to promote financial stability.

Regulatory focus is on:

Group supervision
Enhanced capital standards
Resolution and resolution planning

The NAIC has been compelled to work with federal and international policymakers like never before.

But how did we get here…

The Dodd-Frank Act:
A Big Deal for Guaranty Funds

A Refresher

Dodd-Frank Enacted July 21, 2010

Two big things for guaranty funds:

Title II resolution mechanism for liquidating systemically important financial institutions

- ❑ All insolvent insurers remain subject to state receivership and GF processes (Even SIFIs)

Federal Insurance Office

- ❑ Insurance Modernization Report released late, 2013.
- ❑ Relatively light touch on guaranty funds
- ❑ Recommended that NCIGF and NOLHGA stress their respective systems

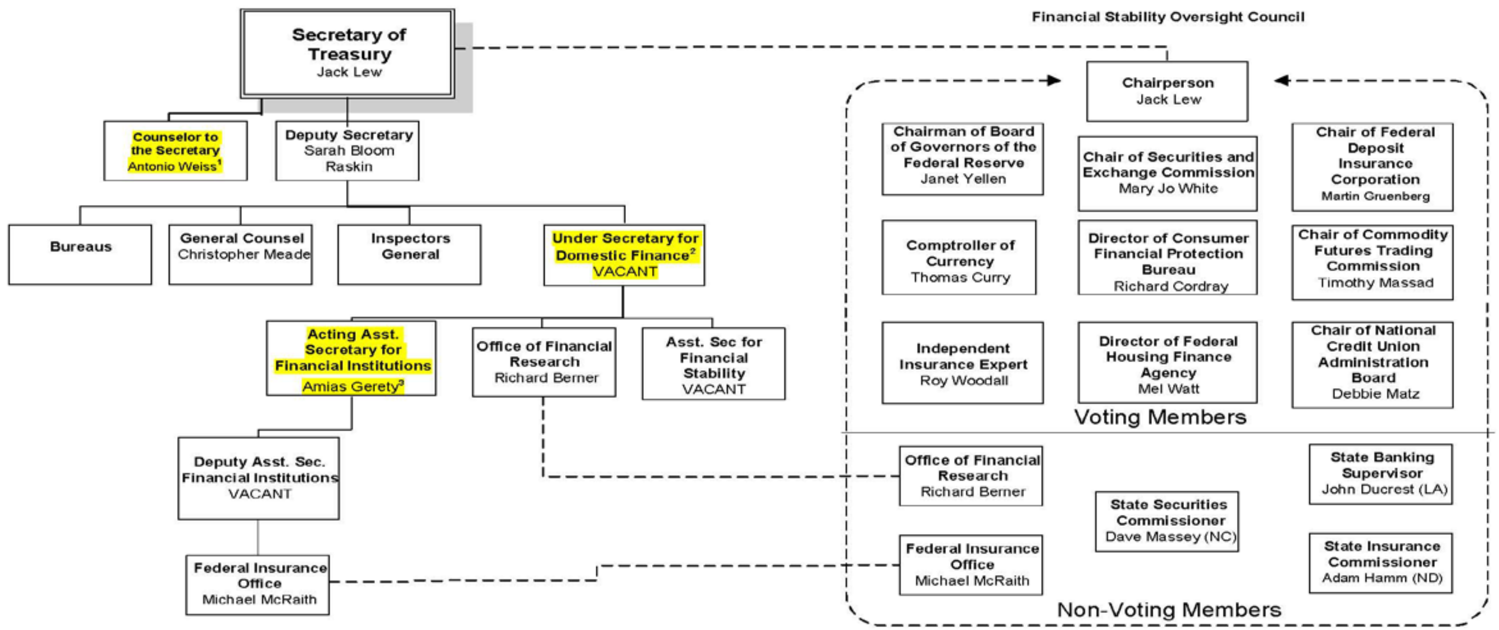
Future of Dodd-Frank

Senate Banking majority and minority staff negotiating changes.

- GOP insists on amendments to FSOC SIFI designations
- Doubtful it will pass or become law
- Expect more “heat” from House and Senate as GOP tries to get something ready for 2017.

United States Department of Treasury Organization Chart and Relationships to Dodd-Frank Act Entities and Other Agencies

As of June 2015



1. Weiss nomination for Undersecretary was blocked; then appointed to position not requiring Senate confirmation
2. Key vacancy after failed Weiss nomination; Matthew Rutherford stepped down early 2015
3. Appointed early 2015

Spanning the Globe:

The Rise of International Insurance Regulation

(Also a Big Deal For Guaranty Funds)

International Association of Insurance Supervisors

- International standard-setting body for the prudential supervision of the insurance industry
- Began developing a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) in July 2010.

ComFrame: 3 main objectives

- Develop methods of operating group-wide supervision of IAIGs
- Establish a comprehensive framework for supervisors to address group-wide activities and risks, and
- Fostering global convergence.

Emergence of the Financial Stability Board

- Established in 2009 by the G-20 nations
- Develops and promotes implementation of regulatory and supervisory policies aimed at financial stability
- US Members are the Federal Reserve, SEC and Treasury
- Interested in Resolution Matters: **Key Attributes of Effective Resolution Regimes for Financial Institutions**. Requires powers very similar to what the U.S. now has between the state guaranty funds and Title II authority granted the FDIC under DFA
- IAIS devising **International Capital Standards** @ FSB direction

Capital Standards and Resolution

Capital standards and resolution matters are not distinct topics. They are actually very closely related.

- ***Capital standards*** **are intended to** ***lessen the chances*** **that an entity will fail**
- ***Resolution strategies*** **are intended to** ***ensure that a failure won't destabilize*** **the economy**
- **How much capital an entity needs is, in part, driven by how it would be resolved. And how an entity can be resolved depends, in part, on how much capital it has.**

In a nutshell, some of the decisions that are being made with respect to capital standards could impact the guaranty system – because they will dictate what resolution strategies are possible.

Some Concerns About Insurance Capital Standards

- No relation between capital standards and the actual operation of insurance business
- No consideration of how risk is measured and how insurance products are priced in response
- Eventually applicable to insurers of all size

What are the Capital Standards Trying to Accomplish?

"One of the questions I have is whether we are trying to prevent company failures or control the effects?"

William P. White, former Commissioner D.C. Department of Banking and Insurance

October, 2013

The Goal of Insurance Regulation Has Already Changed

Move from singular focus on policyholder protection to dual focus on policyholder protection and financial stability

- **Capital standards and resolution strategies aimed at minimizing the impact of a company's failure on the broader financial system**
- **Fed Insurance Advisor Tom Sullivan's primary focus is not policyholder protection--he has to focus on financial stability first**
- **IMF Financial Sector Assessment Program (FSAP) raises questions about the guaranty system's inability to provide bail-out funding to troubled companies**

What's driving these changes?

- Insurance growth is in emerging markets
- U.S. regulators see AIG as success story because no policyholders were hurt. International regulators see it as a <u>failure</u>.
- Different mindset to regulatory approach
- U.S.= policyholder protection
- International = Counterparties
- Possibly a different concept of "insurance?"
- Is risk sharing still a valid business model? How about in 5 years or 10?

Whether action is at the federal level, internationally or at the NAIC, it's often the same people in the room shaping the outcome

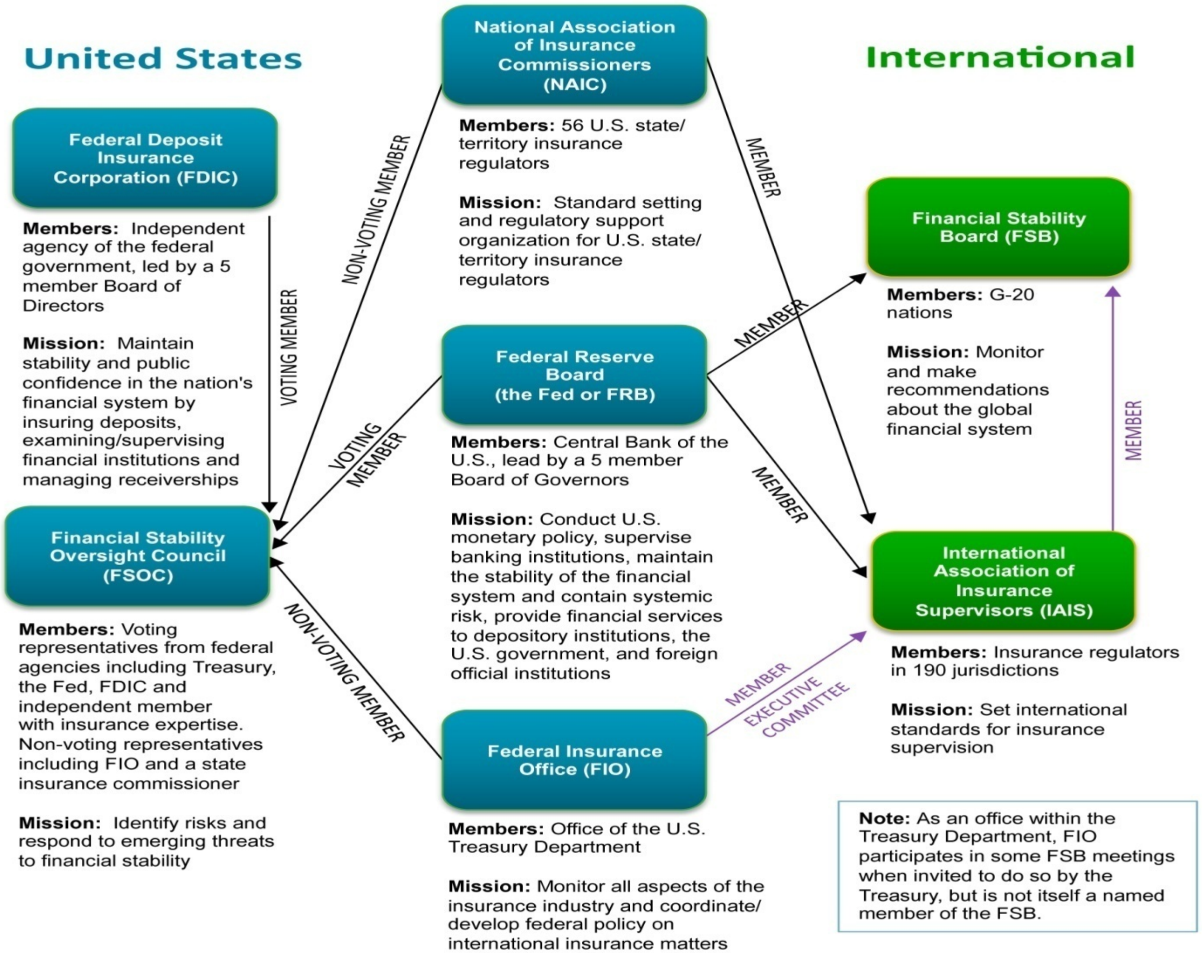
- **Federal Reserve Board**, FIO and IAIS regularly send representatives to NAIC meetings

- The NAIC, **Fed** and FIO all are members of the IAIS, with FIO playing a leading role in the development of the international capital standard. FIO and the NAIC participate in the IAIS resolution group.

- The **Fed** is a key driver at the FSB, establishes resolution standards and is the impetus behind the international capital standard. FIO is a member of the FSB's resolution group.

Key Players Impacting Insurance Regulation

A Complex Web of Interactions



Well-known but don't forget

Prominent role being played by bank regulators, who have bank-centric experience, perspectives and anxieties

- FSOC is convinced that insurers are subject to a run on the bank scenario, in which policyholders concerned about their insurer's financial condition will surrender their products and demand their money all at the same time
- FSOC fears that if one insurer fails, policyholders of other insurers will engage in the same type of surrender activity, possibly leading to a wave of failures
- These bank-centric fears provided a basis for designating Prudential and Met as SIFIs

IMF Financial Sector Assessment Program

- Provides in-depth examinations of countries' financial sectors. FSAPs are done by the IMF alone in advanced economies. FSAPs in advanced economies focus on the financial stability assessment.

- 25 jurisdictions with financial sectors that have the greatest impact on global financial stability—or "systemically important" financial sectors— undergo in-depth reviews of their financial health by the IMF every five years.

- Systemically important financial sectors emphasize interconnectedness among financial sectors, takes into consideration the potential for price contagion across financial sectors; and adheres to principles of relevance, transparency, and even-handedness.

IMF! Insurance. WTH?

- Created in 1945, the International Monetary Fund (IMF) is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

- The IMF's primary purpose is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other.

- The Fund’s mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability.

IMF Financial Sector Assessment Program

- Compared the U.S. insurance insolvency system to the Financial Stability Board's Key Attributes of Effective Resolution Regimes

Initial findings:

IMF assessors rigidly applied the bank-centric Key Attributes of Effective Resolution Regimes without regard for the insurance-specific annex to the Key Attributes

Criticism that U.S. system prioritizes policyholder protection over financial stability

BREAKING NEWS. July 7, 2015: IMF Releases its Technical Review of How the U.S. Insolvency System Compares to the Key Attributes of Effective Resolution Regimes for the Banking and Insurance Sectors

- Although, the U.S. resolution regime for financial institutions has been significantly enhanced since the financial crisis, important gaps in the insurance resolution framework remain that could undermine the regime's ability to deal effectively with systemically important insurance companies

- State resolution frameworks are directed primarily towards the protection of policy holders and provide for a largely court-driven, receivership process which may lead to delays.

- Where an insurance company comes under a holding company, which can be resolved under federal law, an additional issue relates to the manner in which state resolution authorities would coordinate with each other and with the federal authorities.

- State frameworks do vary and such variance could hinder the prompt resolution of a systemically important insurance group.

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And that's not all…

- Guaranty funds are legally required to protect policy holders in the event of insolvency, but they are not required to do so prior to insolvency (IMF thinks they should be).

- The funds are authorized to borrow from commercial banks or issue bonds, but not from the public sector.

- The liabilities of the failed insurance company are generally paid out over an extended period and are typically funded from the assets of the estate (at least they got that right—finally!).

- However, it is unclear whether the financial capacity of the funds would be sufficient to address a systemically important insurer (Doggone it).

- **Primary Recommendation:** The U.S. resolution regime, as enshrined in the [Dodd-Frank Act], should apply also to systemic insurance companies. (Requires an Act of Congress)

Thoughts on the back of an envelope..

- No statutory movement to change the guaranty system trigger.
- Troubled company bailout runs counter to the whole public policy purpose of the guaranty system and the stated goals of Dodd-Frank (AIG/Greenburg decision seems to support this policy).
- GFs are collaborative and coordinated through NCIGF and NOLHGA. That's <u>why</u> they were established!

Resolution Issues: The. Next. Big. Thing.

You Will Hear A Lot About This. Both the IAIS and the Financial Stability Board (FSB) have begun work related to resolution matters

- The **IAIS** Resolution Working Group has focused on revising the international core principles (ICPs) that will form the basis for the segment of ComFrame that deals with resolution matters. Of note: positive collaboration by Fed, NAIC and FIO.
- ComFrame Module is anticipated to be out for consultation in 2016 and field tested 2017.

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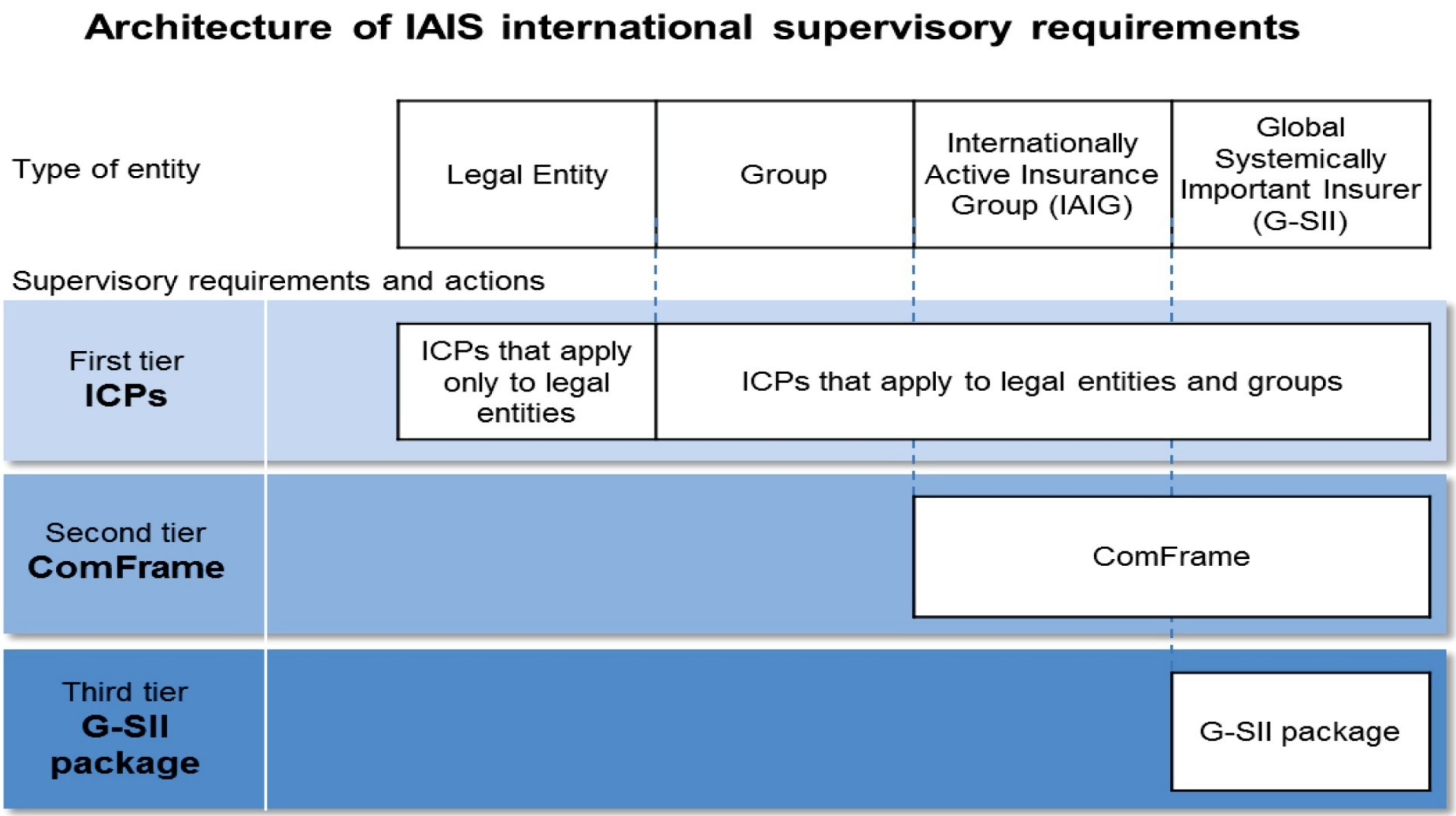
- The **FSB** also has a resolution working group, working on a guidance paper related to critical functions and resolution strategies that supervisors of GSIIs could consider .
- The **FSB** group is also considering the structure and use of Crisis Management Groups (CMGs) for GSIIs, **including the role of policyholder protection schemes** and creditor hierarchies.

International Core Principles (ICPs)

- The ICPs are designed to provide a globally accepted framework for the supervision of the insurance sector. All jurisdictions that are members of the IAIS agree to implement insurance regulatory regimes that comply with the ICP standards.

- ComFrame is a set of international supervisory requirements focusing on the effective group-wide supervision of IAIGs and GSIIs. Once adopted, IAIS member jurisdictions will be expected to adopt or revise their insurance regulatory systems to comply with ComFrame elements.

A peek into the IAIS process…



Relevance of GF System

- Dodd-Frank Title II
- IMF
- FSOC Designations
- FDIC SPOE
- NCIGF Trusted Expertise
- MetLife v. FSOC: ACLI amicus cites GF system's protection, coordination and "vast assessment capacity."

The Worry Room

- Ongoing federal skepticism/premature capitulation
- Changes to/replacement of system , at least for SIFIs, to meet international expectations
- Trickle down effect: Rating agencies may incorporate capital standards into rating criteria = competitive stress
- Capital standards will drive insurers to take greater risks/GF preparation
- No more liquidations/impact on consumers

NCIGF Moving Forward

- Guaranty Funds as continuity when needed
- Proactive assertion of the U.S. safety net model (IFIGS Membership)
- Grow into our role/Be who we are now!
- Address perceived weaknesses of capacity, consistency and de-centralization

Questions

Thank You!

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