

COUNTING THE HOUSE

As banking and insurance mingle, actuaries will not only take on new significance, they'll be playing to a whole new audience.

Actuaries and Financial Services Reform

BY THERESE M. VAUGHAN

After years of debate,

Congress has finally enacted financial services reform. On November 12, 1999, President Clinton signed into law S. 900, or the Gramm-Leach-Bliley Act (GLBA), legislation that could dramatically alter the structure of financial services in this country.

Of greatest significance to the insurance industry, GLBA eliminated previous limitations applying to bank sales of insurance and to affiliations between banks and insurers. Before GLBA, national banks were limited to selling insurance in places with populations under 5,000. GLBA permits national banks to establish a "financial subsidiary" that may sell insurance freely or engage in certain other insurance activities, such as claims administration or underwriting in limited areas.

GLBA eliminated the prohibitions found in the Depression-era Glass-Steagall Act. With few exceptions (such as mortgage reinsurance and credit insurance), insurance underwriting must occur in an affiliate of the bank, not a subsidiary, with both entities owned by a "financial holding company" regulated by the Federal Reserve.

It has often been said that GLBA is fundamentally a bill about the regulation of financial services, one that formalizes a system of functional regulation in the United States. One of the main results of GLBA is an allocation of regulatory responsibility among the various functional regulators (insurance, securities, and banking). Insurance regulators regulate insurance activities, regardless of where they occur.

Predictions regarding the impact of GLBA vary widely. On

the one hand are those that predict a tidal wave of bank acquisitions of insurers and, to a lesser extent, insurer acquisitions of banks. Citigroup, created in 1998 by the merger of Citicorp and Travelers, is cited as a model. Certainly, bancassurance has emerged as an important force in Europe. (Witness Netherlands-based ING, for example.) Most observers, however, predict less dramatic effects. They point to the difference in return on equity between banking and insurance and question why banks would be interested in purchasing insurers. They also argue that banks and insurers can capture the benefits of cross-selling by forming strategic alliances, and that mergers are neither necessary nor likely.

Regardless of the specific impact of GLBA, clearly the financial services market is undergoing dramatic change. Globalization, convergence in products and markets, and consolidation in all sectors are transforming the market. A number of insurers have formed thrifts, particularly in the life insurance sector. The insurance industry competes head-to-head with banks and securities firms in the asset accumulation area, catastrophe risk solutions, and enterprisewide risk management tools. The insurance business is becoming increasingly complex. Affiliations will only add to that complexity.

Perhaps the most significant effect of GLBA is that it formally makes insurance an integral part of the broader financial services market. Increased communication and cooperation among functional regulators are certain. For the past two years, U.S. banking, insurance, and securities regulators have been engaged

in active dialogue, sharing information about our respective regulatory tools and techniques and learning from each other. Globally, cooperation among banking, securities, and insurance regulators is at an all-time high.

Recognizing the need for close interaction among functional regulators, some countries have created integrated financial services regulators who provide oversight on a cross-sectoral basis. (The United Kingdom's Financial Services Authority, for example, regulates all three sectors.) These efforts, both domestically and around the world, are likely to lead to cross-fertilization in regulatory approaches in the various sectors.

Other examples of increased coordination by banking, insurance, and securities regulators abound:

■ On the heels of the global financial crises that began in Asia in late 1997, the G-7 finance ministers and central bank governors sponsored the formation of the Financial Stability Forum (FSF), consisting of G-7 finance ministers, the IMF, the World Bank, and representatives of international associations of regulators in insurance, banking, and securities—the International Association of Insurance Supervisors (IAIS), the Basel Committee on Banking Supervision (BCBS), and the International Organization of Securities Commissions (IOSCO). The stated purpose of the FSF is to address vulnerabilities in the global financial architecture, and the FSF has recommended that the IMF and the World Bank monitor the adequacy of financial regulation systems around the world. Core principles for regulation previously developed by the IAIS, IOSCO, and BCBS will serve as the basis for the IMF/World Bank assessment program, and each of the three regulator organizations has developed guidance for the IMF/World Bank assessments. The IAIS is also drafting a paper on potential vulnerabilities in the insurance sector, for consideration by the FSF.

■ The Joint Forum (formerly Joint Forum on Financial Conglomerates) was created by the IAIS, BCBS, and IOSCO. Its current mandate includes financial conglomerate issues and cross-sectoral issues. The Joint Forum recently created working groups to do cross-sectoral comparisons in three areas: core principles, risk assessment and capital, and corporate governance and transparency.

■ The Multidisciplinary Working Group on Enhanced Disclosure was created by the Committee on the Global Financial Systems of the G-10 Central Banks (CGFS) and the IAIS, BCBS, and IOSCO. This group is studying the feasibility of enhanced disclosure of risk by financial institutions as a means of promoting market discipline. For insurance, the most significant challenge has been the differences in the way banks and insurers assess risk.

A constant theme in these international and domestic efforts is an emphasis on risk assessment and risk management. Responding to increased complexity in the banking sector, most international banking regulators moved to a system of risk-based supervision of banking entities during the 1990s. This approach emphasizes the need for a strong internal risk management program as the front-line defense against insolvencies.

Banking regulators began to scrutinize the firm's risk management practices and to rely more on the company's own processes for assessing risk. In fact, for some banks, capital requirements are based, in part, on the results of the bank's own value-at-risk (VaR) modeling.

It's not difficult to draw an analogy to insurance. There are numerous examples where regulators have already begun to focus systematically on insurer risk management processes. For example, the NAIC's Life and Health Actuarial Task Force and the American Academy of Actuaries are developing a Unified Valuation System (UVS) that would replace current reserving requirements, providing a company-specific, holistic approach to assessing reserve adequacy from an asset adequacy perspec-

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tive. The NAIC Securitization Working Group will recommend necessary elements of a risk management program where an insurer engages in securitization of underwriting risk. A new Life Liquidity Risk Working Group will be making recommendations related to the management of liquidity risk in life insurers. The NAIC's Financial Reporting Working Group has also reached the conclusion that increased complexity in insurance creates regulatory challenges, and it's looking at changes to the examination system to make better use of a company's own risk assessment and risk management processes.

As with banking, increased complexity in the insurance industry is leading to greater scrutiny of how insurers identify and assess risk. This scrutiny is coming from many places—rating agencies, securities analysts, and regulators. The increased cross-fertilization among regulators caused by implementation of S. 900 can only accelerate this trend.

Another theme that has emerged

is the search for consistent approaches to risk assessment in the various sectors, what Jeffrey Carmichael, chairman of the Australian Prudential Regulatory Authority (APRA), refers to as the "Holy Grail for integrated regulators ... a single, comprehensive framework for analyzing risk that can be applied consistently across all supervised institutions."

Today, the approaches used for risk assessment in the in-

insurance industry are quite different from those that have evolved in the banking world. Some of these differences are the natural result of fundamental differences in the business—the longer time frame in insurance, as well as the absence of readily available market values for liabilities. Nonetheless, the differences impede the development of an enterprisewide approach to capital allocation and performance assessment, and conglomerates have begun to search for ways to integrate the approaches in the various sectors.

With or without GLBA, these trends are clear: increased complexity, increased attention to the risk assessment practices of insurers and financial conglomerates generally, and an attempt to harmonize risk assessment in the various sectors. Because actuaries are the insurance industry's foremost experts in risk assessment and risk management, their role in this evolution will be critical. For actuaries, specific implications of this unfolding new world of financial services include:

- Actuaries must continue to improve upon the risk assessment tools in the industry. Dynamic financial analysis and dynamic financial condition analysis will become increasingly important.
- Companies and regulators alike will search for enterprise risk measures that encompass both asset and liability risks, and ac-

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tuaries will be in the forefront in developing those measures. Actuaries will have to understand the asset side of the balance sheet as well as they understand the liability side. Given the interest rate exposure on both sides of the balance sheet in life insurance, the life sector has made some progress in this area. On the casualty side, the Casualty Actuarial Society recently revised its exam structure to require more depth on investments and dynamic financial analysis—a wise move given the trends.

■ Actuaries must better understand the tools and language of risk management in the other sectors, and understand how the risk profile in insurance differs. As this search for the "Holy Grail" of a single approach to risk assessment evolves, actuar-

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ies must be able to identify and clearly articulate how the unique characteristics of the insurance industry should be considered.

■ For insurers that become part of a financial holding company, actuaries will be challenged to develop enterprisewide risk measures that integrate risks in the various sectors.

■ Financial convergence has increased the pressure for harmonization of regulatory approaches in the three sectors. Regulators are concerned that conglomerates will engage in regulatory arbitrage—placing operations where the regulatory environment is favorable. Long term, there will likely be some effort to harmonize capital requirements across sectors, although it promises to be a formidable task. Given the involvement of actuaries when the NAIC's risk-based capital standards were developed, one can expect actuaries to play a major role if and when capital requirements are reviewed.

■ Pressure to harmonize international accounting standards for insurance will continue, as will pressure to move to greater consistency across all sectors. Harmonious capital requirements are meaningless if accounting standards are discordant, and consistency in reporting facilitates a logical cross-sectoral approach to risk. The search for consistent accounting standards across sectors will result in continued attention to the concept of fair value accounting in insurance. Fair value for insurance liabilities is

essentially an actuarial problem, and it's certain that actuaries will play a significant role in this discussion.

■ The actuarial profession will continue to evolve in response to this changing environment. There will be increased emphasis on asset risk and financial modeling in exams and professional standards. The search for harmonized approaches to risk assessment will promote increased cooperation between casualty and life actuaries, and both groups will pursue greater dialogue with those risk assessment professionals in the other sectors.

The face of the insurance industry

in 10 years is unclear. What is clear, however, is that there will continue to be a significant role for actuaries. In fact, as actuaries bring their risk assessment skills to the broader world of financial services, their role could easily broaden. For that to happen, actuaries must continue to develop skills enabling them to bridge the gap between insurance and the other sectors. ●

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