

ERM and Regulatory Reform

National Underwriter's ERM Summit

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Discussion Outline

- **Background**
 - Causes of the financial crisis
 - Lessons learned
 - Fundamental risk management principles
- **Principles of an effective regulatory framework**
- **Modernizing the US regulatory framework for financial services**
 - Issues to be considered in reforming insurance regulation
 - Challenges in modernizing the regulatory framework
- **What does the future hold? Some predictions....**



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- Serves as the public policy arm of US actuarial profession
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Answers to the \$64,000 Question: What caused this financial crisis?

- Lack of institutional and personal responsibility
- Too much regulation OR too little?
 - Unregulated CDS market
 - Regulatory failure to monitor activities (e.g., Madoff, Stanford, AIG, FNMA/FHMC)
 - Patchwork of regulations governing complex financial institutions
 - Legislation or regulation designed to help or penalize one aspect of the market that does not consider the systemic implications on the larger market.
- Markets and transactions with a high degree of correlation or interdependence
- Misguided or misunderstood accounting rules
- High levels of leverage
- High or rapidly increasing levels of risk concentrations



Answers to the \$64,000 Question: What caused this financial crisis? (cont.)

- Mispriced risk
- No oversight of systemic risks
- Misalignment of incentive compensation with risk
- Failure of ERM in some institutions
 - Development of overly complex products with misunderstood risks
 - Over-reliance on poorly constructed models
 - Over-reliance on rating agencies – no independent review of ratings
 - Compliance and cultural issues



Lessons Learned

- There is **no single cause of the financial crisis**; blame must be shared by individuals, companies, legislators, and regulators.
- Big lesson learned for ERM practitioners is that **the value proposition of ERM has STILL not yet been proven.**
 - Many companies simply did not understand their risks OR were betting that the risks would not materialize. CROs struggled to be effective.
 - Rating agencies have probably done most to promote ERM.
 - A culture of risk awareness is essential to managing through business cycles.
 - Active involvement by company management and the Board of Directors is critical.
- **Conflicting objectives of stakeholders must be balanced** in managing a company and the broader economy (short term profits vs. long term viability, revenue generation vs. value creation, consumers vs. investors vs. employees).



Lessons Learned (cont.)

- A one-size fits all, transaction-based, and rule-based **regulatory framework is no longer sufficient** given the products and markets where companies operate. The influence of consumer demand, technology, global markets, and the desire for growth and profits has produced increasingly sophisticated products.
- **Both the company's risk management practices and the regulatory framework need to be modernized!**



Fundamental Risk Management Principles

- The goals of risk management
 - Strategically manage risks: transfer, mitigate, eliminate
 - Ensure profitable, sustainable business
- The evaluation framework should include all risks, on and off the balance sheet, and aggregate results across all legal entities
- Assessment should be based on fundamental risk analysis, supplementing analysis specific to particular accounting regimes.
- Evaluation of risk should be made relative to the firm's appetite for risk, where that appetite reflects the conflicting objectives of stakeholders
- Risk reporting must be transparent and traceable from creation of the risk through each transaction where risk is transferred.



Similarities in Implementing ERM: Company vs. Regulation

- **When**
 - Successful ERM is not an audit process conducted after decisions are made, but part of strategic discussions and the cultural fabric of the organization.
 - Regulation needs to be based on a more cooperative model between companies and regulators.
- **How**
 - Effective regulations are not based on rules, but instead evaluate company stability based on company's risk profile, operating practices, and ERM practices.
 - Regulatory framework needs to discourage company practices of attempting to get around poorly designed rules that restrict competition and create incentives to mismanage risk.
- **Who**
 - Company ERM functions need practitioners, dedicated to the ERM function and skilled in ERM principles, with sufficient resources & tools.
 - Regulators must be knowledgeable in ERM principles and trained to evaluate the effectiveness of company risk management programs.
 - Company management, risk professionals, Boards of Directors, and regulators acknowledge the change in their roles for more effective oversight.



Principles of an Effective Regulatory Framework

- **The public's interest is best served by establishing regulations that provide:**
 - adequate consumer protection
 - transparency of information
 - early warnings to pre-empt or minimize failures

- **Regulatory authority works best with a system of checks and balances including transparency and accountability**
 - Regulators are accountable to perform ongoing assessments of regulatory framework and modify as appropriate.
 - Those involved with the reporting, management, and oversight of company operations must adhere to professional standards of practice.



Principles of an Effective Regulatory Framework (cont.)

- **Regulators must understand:**
 - confidence to consumers and investors is essential component of US financial system
 - Overarching regulations can restrict growth and innovation

- **Legislators must understand:**
 - the impact of legislative mandates: FAIR vs EQUITABLE
 - the impact of public policy – not only in terms of the benefits inured to one sector of the market, but also in terms of the impact on the rest of the sector and the overall economy .

- **Investors and other market participants must understand:**
 - a shareholder perspective is value-based
 - the investor perspective will never be fully aligned with a regulatory regime designed to protect policyholders.



Modernizing the US Regulatory Framework for Financial Services

- **Build on a foundation of fundamental risk management principles**
 - Regulate products and transactions based on fundamental risk analysis, rather than the legal entity structure or accounting/reporting requirements.
 - Establish regulations consistent with the way companies operate; leverage company tools and risk management practices.
 - Regulate holistically, based on company's aggregate risk profile.
 - Regulate with an awareness of the impact individual company decisions have on the entire financial system.
- **Provide comprehensive oversight across all financial sectors to prevent regulatory arbitrage**
 - Uniformly regulate across regulatory/supervisory authorities.
 - Recognize the global marketplace.



Modernizing the US Regulatory Framework for Financial Services (cont.)

- **Focus regulators on the risks assumed by a company**
 - with support from a risk-focused audit process from the top down; shift focus away from transaction-based audits.
 - equipped with sophisticated tools and personnel trained to understand risks and complex business operations.

- **Allow flexibility**
 - Adapt to new products, markets, or other developments with a bearing on any party's ability to satisfy an obligation.
 - Adapt to new products, markets, or other developments with potential to destabilize financial system.
 - Adapt to new and emerging risks.



Issues to be Considered in Reforming Insurance Regulation

■ **Scope:**

- Should insurance be regulated along with other financial sectors (banking, brokerage, insurance, securities)?
- To what extent should the reformed framework streamline the patchwork quilt of regulators?
- How should reformed framework close gaps in the regulatory system (e.g., unregulated sectors, holding companies)?
- Does proposed regulatory framework over-reach by creating regulation for sectors that were not a source of problems in recent economic crisis?

■ **How much can and should regulation influence the effectiveness of ERM practices? Consider:**

- Counter-cyclical capital requirements
- Stricter regulation of systemically significant firms
- Compensation guidelines that align risk and return over the long term



Issues to be Considered in Reforming Insurance Regulation (cont.)

- **How will the federal government interact with the states?**
 - When should government intervene with failing or failed institutions? And which agency?
 - What is the role of the federal government in regulating systemic risks? Feasible? Does SRR decrease or increase risk?
 - Which agencies would have expanded insurance authority?
- **To what degree will framework converge with international practices?**
- **What are the costs of compliance?** How will additional capital requirements affect returns as both the level and cost of capital could be affected for some companies?
- **Will proposed regulatory framework stifle growth and innovation?**



Challenges in Modernizing the Regulatory Framework for Companies

- Articulation of risk appetite is challenging
- Translation of risk appetite into day-to-day operating guidelines is difficult
- The institutionalization of ERM can change how companies make decisions, shifting from cost/benefit to risk/return emphasis.
- Risk models and supporting system infrastructure are necessary, along with routine reporting and rigorous analysis of risk positions.
- Trained risk professionals are essential.
- Communication between risk professionals and business areas is key to unlocking the potential of ERM



Challenges in Modernizing the Regulatory Framework for Investors

- Enhanced risk information from a company's ERM program provides new information for investors to assimilate.
- Stock analysts may need training to manage and reflect risk in their analysis.
- Communication between company management and investors is key to unlocking the potential of ERM.



Challenges in Modernizing the Regulatory Framework for Regulators

- Principle-based regulation is a paradigm shift for regulators.
- New tools to monitor an individual company's risk profile are needed
- New tools to monitor shifting risks to the entire financial system are needed.
- Trained risk professionals are essential and in short supply.
- Communication between regulators, company management, and legislators is key to effective regulatory framework.



What does the future hold?

Some predictions....



- The US and global economies will rebound and the mortgage crisis will subside.
- Some regulatory reform of the financial services industry will be passed by Congress.
- Regulatory reform will be piecemeal, falling short of comprehensive modernization.
- Public policy makers will continue to pass legislation without full appreciation for its impact on all aspects of the economy.



What does the future hold? Some more predictions....



- More companies will embrace ERM.
- More CRO positions will be created and more aspiring risk professionals will also be created.
- More ERM conferences will be held.
- ERM practitioners will continue to espouse the benefits of ERM
- A new financial crisis, not related to the subprime mortgage market, will befall the US and global economies.
-and the cycle starts all over again with smarter, albeit older, players.

