

A brave new world for insurance companies

Federal oversight and banking regulation - two generational changes to consider

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Section 1 – Point of view

Section 1

Point of view

The insurance industry is on the cusp of regulatory change that will have far-reaching effects.

While several attempts have been made in recent years to move toward a framework with more federal regulation, the current degree of focus and attention on the topic is unprecedented. The details of the final structure are far from certain; however, it is likely that the Federal Reserve will play a vital role as the “systemic risk” regulator. Whatever the final outcome, the regulatory landscape will be a significant departure from the current structure.

Recent industry events and the associated public response have highlighted the significant role of insurance companies in our financial system.

Given this increased attention, companies should expect a call for greater transparency into their operations and governance. More complex institutions, in particular, will likely be subject to greater consolidated oversight.

If adopted, a federal insurance regulatory structure will enable insurers to harness efficiencies that are not possible with the current state-based system.

The Obama Administration’s “New Foundation for Rebuilding Financial Supervision and Regulation” proposes the establishment of the Office of National Insurance (ONI) within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. The ONI will also help facilitate the identification of any insurance companies that could be considered a “Tier 1 FHC” which will be subject to consolidated supervision by the Federal Reserve.

Section 1

Point of view

Insurance companies' approach to compliance should evolve in a manner consistent with other financial services institutions.

Unlike many banking institutions, which have been subject to federal oversight for many years due to their bank holding company (BHC) status, many insurance companies will find it necessary to augment their compliance and risk functions to meet the expectations of federal regulators. In fact, according to the Obama Administration's proposal for regulatory reform, an insurance company that owns and insured depository institution such as a Savings and Loan Association (Thrift) or an Industrial Loan Company (ILC) would be covered under the Bank Holding Company Act (BHC) of 1956 and subject to consolidated supervision by the Federal Reserve. As such, affected insurance companies would be subjected to prudential standards regarding capital, balance sheet leverage, and liquidity and other standards of safety and soundness standards, including enterprise-wide compliance and risk management, required by the Federal Reserve.

While approvals for the Troubled Asset Relief Program (TARP) are currently being considered, insurance companies that gain access to these funds should prepare for a new set of expectations from additional external stakeholders.

By receiving this funding, insurers expose themselves to increased public scrutiny and added regulatory expectations. While such capital infusions may be vital for ongoing financial strength, insurers should prepare their organizations for the elevated expectations of a company that receives government assistance.

Section 1

Point of view

The new regulatory framework will require greater integration of risk management and compliance efforts.

With the potential for a systemic risk regulator for insurers of a certain size and/or scope, there has never been a more compelling time for the risk management and compliance functions to collaborate. To meet regulatory expectations, each company should:

- Rely upon information and data analytics from the company's enterprise risk management program
- Fully address all applicable risk areas, including operational risk, treasury risk, and liquidity risk

Risk management and compliance should work hand in hand if the company is to be perceived favorably by the federal oversight body, particularly if the federal regulator is responsible for setting capital requirements.

Preparing for these changes will require a shift in mindset and a substantial planning and execution effort.

Recent reviews by top insurers of their compliance and risk functions have, in some cases, identified major areas for improvement. The landscape is about to change significantly, particularly for those insurers who will be subject to the bank regulatory model at some level. Even companies that have made recent updates to their risk and compliance functions should objectively examine their ability to meet the more sophisticated expectations within a federal and potentially banking regulatory oversight structure.

This paradigm shift will require companies to challenge the current state of their compliance and risk functions, including:

- Adequacy of talent
- Value of these functions provided in light of the significant cost to the organization

A detailed gap analysis and implementation strategy will be necessary to help ensure that the company is able to navigate the following two fundamental challenges:

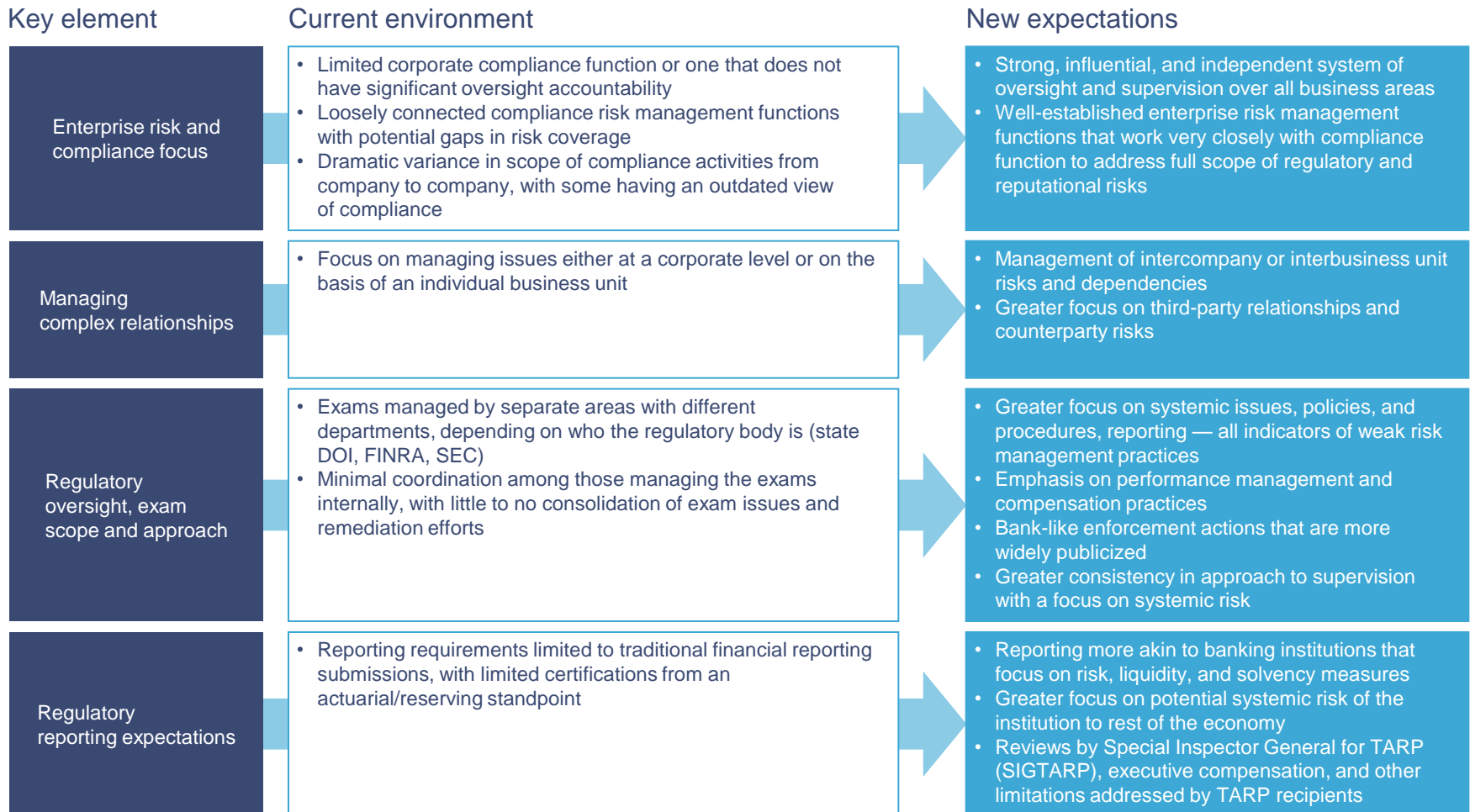
- Impact of banking regulation on insurance
- Movement to a national charter

Section 2 – Current situation

Section 2

Current situation

Some key differences in regulatory approach may have a significant impact on how insurers address compliance risk management.



Section 3 – A framework for response

Section 3 – A framework for response

Three-step approach

Insurers should follow a three-step approach as they prepare for a potential holding company model.

Step 1:

Design the holding company future state

- Articulate a vision of the future-state holding company organization and capabilities
- Conduct management validation meetings and working sessions
- Create a detailed design of the future-state organization and capabilities
- Set target conversion timeline
- Articulate expected benefits from holding company conversion in terms of organizational and risk management efficiency and effectiveness

Step 2:

Assess the holding company gap

- Set up steering committee
- Analyze expected changes linked to holding company conversion
- Assess the holding company gap relative to existing environment, focusing on:
 - Governance and organization
 - Roles and responsibilities
 - Policies
 - Culture and incentives
 - Risk

Step 3:

Build holding company capabilities

- Define and prioritize a portfolio of initiatives to operationalize the holding company organization and capabilities
 - People
 - Processes
 - Resources & Infrastructure
- Coordinate and manage the execution of implementation initiatives through a program office
- Measure progress and communicate results

Regulatory consultation and dialogue

Section 3 – A framework for response

Key considerations

The following stakeholder groups should assess how this change will affect how they carry out their responsibilities:

- Board and audit committee
- Senior management
- Risk management leadership
- Compliance leadership
- Business unit management
- Internal audit

Changes will include new activities in addition to enhancements to current programs. Key areas of focus include:

- Scope of element
- Roles and responsibilities
- Board reporting
- Regulatory reporting
- Issues management
- Culture/tone at the top
- Tracking of laws and regulations
- Policy setting
- Testing
- Training and communication

Section 3 – A framework for response

What this means for key stakeholders

Stakeholder groups should assess how this change will affect how they carry out their current responsibilities.

Stakeholders	How federal and/or banking regulatory oversight will affect these stakeholders
Board and audit committee	<ul style="list-style-type: none"> • Greater involvement of the board in the oversight and direction of management; will require redesign of certain board governance processes. • Enhanced focus on legal and reputational risks for the company. • Need for greater visibility into new categories of risk. • Need for initial and ongoing education related to current and emerging regulatory expectations. • Need to ensure that the right talent is in place to respond to this change. • Tone/culture geared toward this new environment should be (re)established.
Senior management	<ul style="list-style-type: none"> • Senior leaders need to share a common understanding of and appreciation for the regulatory environment, including education as to the regulatory expectations of bank regulators and the Treasury (if a TARP recipient). • Business decisions may require a sharper regulatory lens, to align with the tone and appetite established by the board. • Performance evaluations and incentives will need to be aligned with risk management expectations. • Risk management information is more critical than ever, and current risk programs may not be adequate. • Budgeting and forecasting need to incorporate enhanced risk management and regulatory reporting requirements.

Section 3 – A framework for response

What this means for key stakeholders

Stakeholder groups should assess how this change will affect how they carry out their current responsibilities.

Stakeholders	How federal and/or banking regulatory oversight will affect these stakeholders
Risk management leadership	<ul style="list-style-type: none"> • Enterprise risk management (ERM) function should be fully established to facilitate decision making by senior management. • For many insurers, this is an area that has not had the right resources and talent—it is time to sure up this function. • Need for a process to identify, monitor, and report on existing and emerging risks.
Compliance leadership	<ul style="list-style-type: none"> • The current scope of the compliance function may not be fully aligned with current and emerging regulatory risks, leaving the chief compliance officer (CCO) feeling exposed. • Compliance functions are not integrated closely enough with enterprise risk management activities, resulting in disconnects in purpose and execution. • Past and current focus has been on state regulators. • In some cases, there will be a steep learning curve to operate at a level expected by federal and/or banking regulators. • There may be additional specific reporting requirements, including those for TARP recipients.

Section 3 – A framework for response

What this means for key stakeholders

Stakeholder groups should assess how this change will affect how they carry out their current responsibilities.

Stakeholders	How federal and/or banking regulatory oversight will affect these stakeholders
Business unit management	<ul style="list-style-type: none"> • Business units that have been focused solely on their own operations should understand the interdependencies with other business units. • Company leadership should ensure that middle management has an appropriate appreciation for the significance of federal regulatory oversight. • Operations leaders need to manage regulatory compliance risks embedded in their major business processes. • Headcount reductions may have left gaps in ownership of regulatory compliance issues. • Process changes in the operations need to be considered for regulatory compliance impact.
Internal audit	<ul style="list-style-type: none"> • Internal audit should collaborate closely with compliance and risk management leaders. • Audit plans should include areas examined by federal regulatory bodies. • Model validation and associated model risk will be key areas of focus for regulators, and internal audit can play a key role. • The accuracy of regulatory reporting hinges on the quality of the data used as inputs, making data governance a key area of focus. • Education of internal audit staff about expectations of federal regulators is essential.

Section 3 – A framework for response

Key areas of focus

Changes will include new activities in addition to enhancements to current programs.

Compliance element	Key questions	Actions required
Scope of program	<ul style="list-style-type: none"> Does the current compliance program include each of the elements expected by federal regulatory authorities? 	<ul style="list-style-type: none"> Identify gaps between current program and existing federal models.
Roles and responsibilities	<ul style="list-style-type: none"> Who will be the point person for federal regulatory interactions? What will the scope of the CCO be vis-à-vis the chief risk officer (CRO) and others? Does the team have the right skills and experience to operate with federal regulators? 	<ul style="list-style-type: none"> Identify required skills of compliance staff and conduct a gap assessment. Conduct a comprehensive review of compliance and risk management programs, using a framework similar to the BHC model, to identify opportunities for more precise clarity, definition, and expectations of key functions. Define responsibilities and decision-making authority across the full scope of topics in a matrix format and memorialize them in performance expectations.

Section 3 – A framework for response

Key areas of focus

Changes will include new activities in addition to enhancements to current programs.

Compliance element	Key questions	Actions required
Board reporting	<ul style="list-style-type: none"> • Is the board staying abreast of regulatory developments? • How is the board informed of emerging risks across the organization? 	<ul style="list-style-type: none"> • Conduct educational sessions for board members on the mechanics and requirements of federal regulatory oversight. • Ensure a mechanism for board members to receive regular briefings on regulatory developments. • Consider the need for a regulatory sub-committee.
Regulatory reporting	<ul style="list-style-type: none"> • Does management fully appreciate the types of information that federal regulators will expect? • Is the company able to access and generate this information in the current environment? 	<ul style="list-style-type: none"> • Identify the types of information that will be required for regulatory reporting and determine the availability of such data and the expertise for analysis of the data. • Institute processes for the data capture, analysis, and review of all information, including identification of those who will certify the accuracy of the data.

Section 3 – A framework for response

Key areas of focus

Changes will include new activities in addition to enhancements to current programs.

Compliance element	Key questions	Actions required
Issues management	<ul style="list-style-type: none"> Does senior management have a consolidated view of all issues with a regulatory compliance risk element? How are these issues managed so that systemic risks are mitigated? 	<ul style="list-style-type: none"> Identify all sources of issues (e.g., regulatory exams, internal audits, investigations, consumer inquiries, investor relations) and who's responsible for each. Develop a means of consolidating the information for senior management and board review, analysis, timely remediation, and closure.
Culture/tone at the top	<ul style="list-style-type: none"> What type of tone/culture is the board setting in light of heightened expectations of the company? What is senior management doing to instill that tone/culture across the organization? What mechanisms does the CCO use to evaluate whether the organization's compliance culture is appropriate? 	<ul style="list-style-type: none"> Identify key areas that will require communication from the board and senior leadership. Size the gap between current and expected state through mechanisms such as a survey on risk culture. Compare the company's program and culture to that of leading financial services companies and companies of similar size and scope. Design a communication and change management plan to address required changes.

Section 3 – A framework for response

Key areas of focus

Changes will include new activities in addition to enhancements to current programs.

Compliance element	Key questions	Actions required
Tracking of laws and regulations	<ul style="list-style-type: none"> • Are there resources to track and interpret new bodies of laws and regulations? • Is there a collaborative and controlled process to implement new requirements across the organization? 	<ul style="list-style-type: none"> • Ensure that the right parties are involved in the interpretation of new requirements and their applicability to the enterprise, rather than to individual business units. • Tighten controls around the implementation and execution of new requirements within business operations.
Policy setting	<ul style="list-style-type: none"> • How will the current approach to setting policy change in this new environment, given the focus on interdependencies across the enterprise? 	<ul style="list-style-type: none"> • Consider establishing a policy review committee to ensure that at the corporate and business-unit levels, there is a means to avoid conflicting or inconsistent policies with a regulatory compliance impact. • Establish formal protocols for setting compliance-related policies, which are grounded in a common set of corporate governance, risk, and compliance principles. • Incorporate the setting of explicit risk appetite and risk limits into policy development.

Section 3 – A framework for response

Key areas of focus

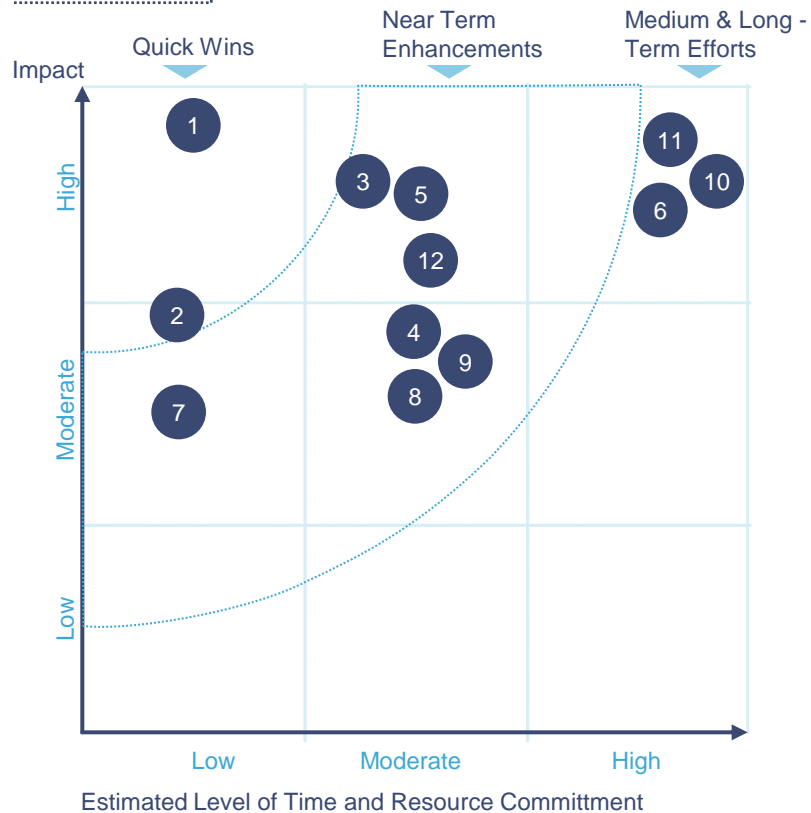
Changes will include new activities in addition to enhancements to current programs.

Compliance element	Key questions	Actions required
Testing	<ul style="list-style-type: none"> • How will the company change/expand compliance testing to address new regulatory expectations? • What group (s) is best equipped to conduct this testing? • What types of data will be needed for monitoring and testing purposes? 	<ul style="list-style-type: none"> • Consider the need to conduct ongoing stress testing of liquidity and capital positions. • Conduct an assessment of data needs and develop processes for accessing required data. • Identify or acquire staff with requisite knowledge of sophisticated testing techniques.
Training and communication	<ul style="list-style-type: none"> • How will the organization gain a full understanding of the implications of these new requirements? 	<ul style="list-style-type: none"> • Develop a comprehensive training plan, starting with a needs assessment of corporate functions, business unit operations, client-facing roles, officers and board members; to first raise the awareness of the changes, apply those changes to specific departments and roles. • Design the training and communication plan as an ongoing initiative that will be rolled out continually over the course of at least a year, to ensure that changes “stick” for all involved.

Section 3 – A framework for response Implementation initiatives

Implementation initiatives can generally be managed like a portfolio, distinguishing between quick wins, near term enhancements, and medium/long term efforts.

Illustrative



Proposed initiatives	
1.	Independent Corporate Risk function
2.	Capital allocation and transfer pricing methodologies
3.	Regulatory reporting
4.	Board committees and oversight mandates
5.	Risk appetite/tolerance framework
6.	Model risk management
7.	New business approval process
8.	Centralized counterparty credit risk management
9.	Issue and action tracking system
10.	Consolidated inventory of Compliance requirements
11.	Enterprise Risk Assessment methodology
12.	Audit programs and work paper standards

Section 4 – How PwC can help

Section 4

How PwC can help

Educate your senior leaders and board members on what federal regulatory oversight will mean for your company.

The potential for federal regulatory oversight requires immediate attention to both how your organization thinks about regulatory compliance risk and how it can implement and execute a compliance strategy that addresses new expectations. Our regulatory specialists can apply decades of experience working with financial institutions and regulators to help you prepare for these potentially sweeping changes.

Determine the key changes your company will need to undertake.

We can help you conduct an assessment of the key areas that will require change under a federal regulatory charter. With our federal regulatory assessment framework, we can quickly identify the nature and size of any gaps in your current compliance environment and provide you a customized and practical roadmap for organizational and structural change, data requirements, process changes, and training and testing.

Assess executive compensation.

There is currently a great deal of public, political and investor attention on executive compensation, particularly at financial services institutions. Our Global Human Resource Services (GHRM) team can apply on your behalf the experience it has gained working with many insurers, banks, asset managers to significantly revamp and align compensation policies.

Assess your company's public-reporting capabilities.

As the leading auditor of insurers and other financial services companies (according to Fortune and AM Best), we can provide you unmatched insight into best practices in financial reporting and transparency.

Determine whether your company's business strategy aligns with your goals.

We can help you rethink your business strategy, including markets, geographies, channels, and clients. Based on your desired outcomes, we can then advise you on the best ways to restructure your organizational model by examining structures, policies, and roles, as well provide guidance on sustainable cost-reduction strategies.

Section 4

How PwC can help

The PwC network is a world leader in governance, risk management, and compliance.

PwC was the primary author of the COSO ERM standard, which is widely viewed as the authority in enterprise governance, and risk management. Furthermore, we have applied this model to a variety of financial institutions, public-sector entities, and public-private partnerships, including bank holding companies and leading insurers.

PwC professionals have specific experience within each of the financial services industry sub-sectors.

- PwC is an advisor or consultant to 46 of the world's top 50 insurance companies and advisor or auditor to 44 of the world's top 50 banks. In these roles, we provide both financial institutions and government entities with insights into global industry leading practices in areas such as valuation, and unique views into technology, risk management, and operations considerations inherent in these structures.
- PwC is a leading service provider to investment managers, pension funds, and hedge funds around the world, providing deep insights into custody and asset management aspects of these structures.
- Our world-leading Transaction Services business provides pre- and post-deal services related to asset acquisition, disposals, and joint ventures to private equity and hedge funds, financial institutions, and governments. In addition, PwC can utilize the services of its in-house registered broker-dealer for contacting US investors in the event of asset/entity sales.

The PwC network provides an independent and global perspective on structuring, design, implementation, and monitoring strategies for regulatory compliance and risk management structures.

- The firm's 34,000 financial services professionals around the world in more than 150 countries have a long history of leveraging lessons learned and experience across borders.
- We have created a Public-Sector Financial Services practice that combines the best of our financial services experience and the global network's leading government practice around the world.
- We have 30 years of experience in assisting governments, multilateral institutions, and the financial services industry in successfully managing financial crises.

Section 4

How PwC can help

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Section 5 – Selected case studies

Section 5

Selected case studies

New financial holding company	
Issue	In conjunction with the creation of a financial holding company structure, a large bank engaged PwC to assist in the establishment of a new ERM framework that leveraged existing risk management processes and satisfied newly elevated regulatory expectations, in alignment with the client's strategic goals.
Approach	PwC deployed a team of risk management and regulatory compliance specialists to assess the firm's existing risk management infrastructure and identify gaps against leading industry practices and regulatory expectations. We reviewed the risk management organization's governance model, policy framework, risk limits, and reporting at the consolidated FHC and subsidiary bank levels. Based on these analyses, we provided recommendations relating to organizational structure, closed policy gaps and enhanced reporting. We are now working with the client to implement recommended changes.
Benefits	At the conclusion of this engagement, the organization's ERM program was better able to contribute to the strategic management of the firm. Additionally, the company was in a significantly stronger position to meet regulatory expectations.

Section 5

Selected case studies

Leading US financial services company	
Issue	The client entered into a regulatory order with its federal bank supervisory agency due to deficiencies identified in its risk management program and processes. The client had concerns that the supervisory agency would have similar concerns about its compliance program and requested our assistance prior to an upcoming regulatory examination.
Approach	PwC reviewed the design of the company's existing compliance risk management program and interviewed numerous key stakeholders. PwC identified key elements of the compliance program including governance considerations; organizational structure; roles and responsibilities; policies and procedures; change management processes; training; testing and monitoring; and internal audit coverage of the function. For each program element, we summarized our understanding of regulatory expectations and industry leading practices. We then compared the company's compliance program and processes against these benchmarks and offered targeted recommendations to remediate significant gaps. PwC then assisted the client with a significant redesign and implementation of an enhanced enterprise-wide compliance framework and program.
Benefits	The new program and processes leveraged existing, scalable risk management activities that received positive feedback from the company's regulators.

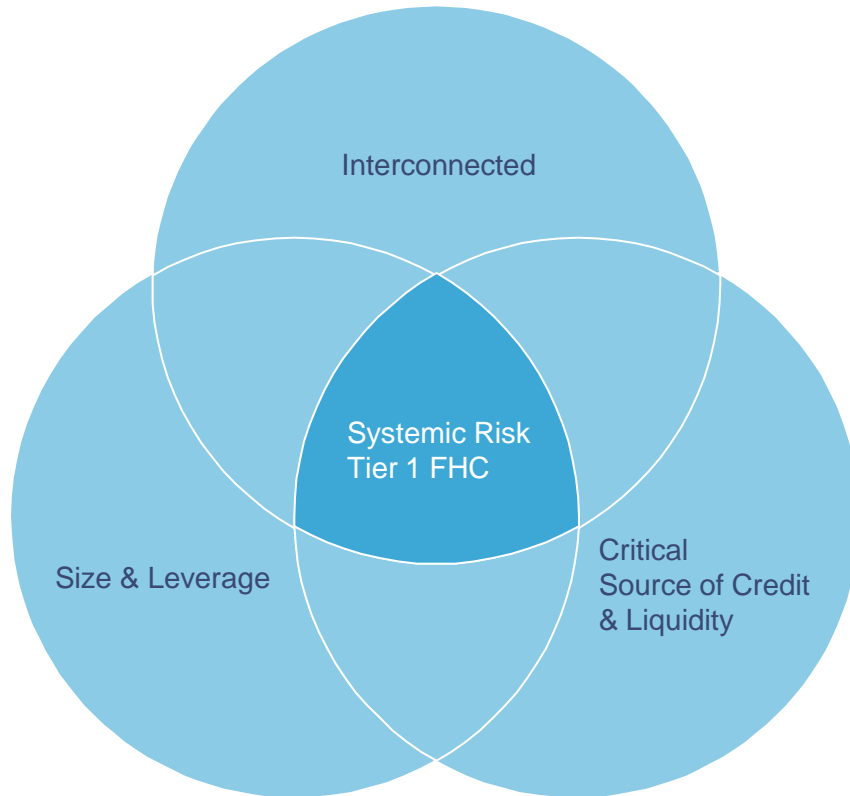
Appendix A

Tier 1 Financial Holding Companies

Appendix A

Tier 1 Financial Holding Companies

Firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness.



Identifying Tier 1 FHCs

- Legislation will specify the factors that the Federal Reserve must consider when determining whether an individual financial firm poses a threat to financial stability. Those factors should include:
 - The impact the firm's failure would have on the financial system and the economy.
 - The firm's combination of size, leverage (including off-balance sheet exposures) and degree of reliance on short-term funding.
 - The firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.

Appendix A

Tier 1 Financial Holding Companies

Consolidated supervision by the Federal Reserve and the prudential standards

Key regulatory authority related to Tier 1 FHCs

- Consolidated supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries – regulated and unregulated, US and foreign.
- The constraints that the Gramm-Leach-Bliley Act (GLB Act) introduced on the Federal Reserve’s ability to require reports from, examine, or impose higher prudential requirements or more stringent activity restrictions on the functionally regulated or depository institution subsidiaries of FHCs should be removed.
- These entities will be subject to robust consolidated supervision and regulation by the Federal Reserve, regardless of whether the firm owns an insured depository institution.
- The Federal Reserve will identify all potential Tier 1 FHCs and will have accountability and authority for consolidated supervision for these entities.
- The subsidiaries will be held to stricter prudential standards than would be required by the functional regulator, whose focus is only on keeping that particular subsidiary safe.
- The focus of BHC regulation will expand beyond the safety and soundness of the bank subsidiary to include the activities of the firm as a whole and the risks the firm might pose to the financial system.
- Federal Reserve should have the authority to collect periodic and other reports from all U.S. financial firms that meet certain minimum size thresholds.

Appendix A

Tier 1 Financial Holding Companies

Consolidated supervision by the Federal Reserve and the prudential standards

Key Tier 1 FHC prudential standards

- Must have enough high-quality capital during good economic times to keep them above prudential minimum capital requirements during stressed economic times.
- Sound processes for monitoring and controlling the full range of their liquidity risks.
- Regularly conduct stress tests across a variety of liquidity stress scenarios, including short-term and protracted scenarios and institution-specific and market-wide scenarios.
- Identify firm-wide risk concentrations (credit, business lines, liquidity, and other) and establish appropriate limits and controls around these concentrations.
- Tier 1 FHCs that do not control insured depository institutions should be subject to the full range of prudential regulations and supervisory guidance applicable to BHCs.
- Each Tier 1 FHC must prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress.
- New capital standards are expected to be issued by Treasury by December 31, 2009.

Appendix B

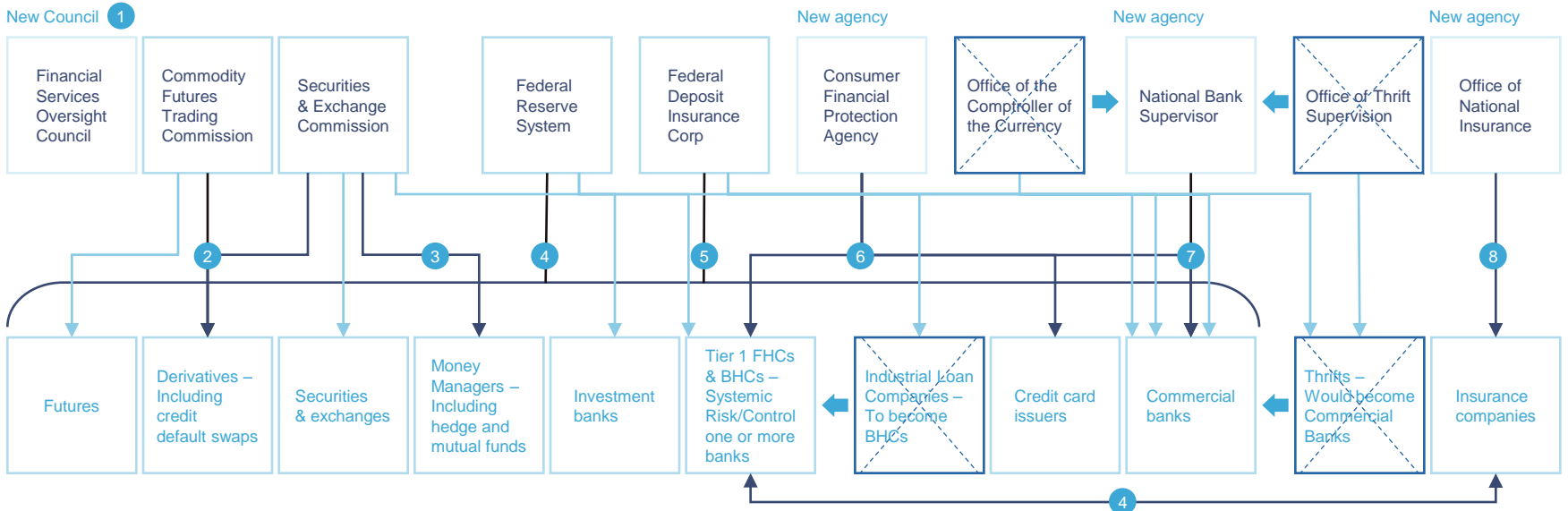
Summary of proposed regulatory changes

Appendix B – Financial reform

New rules and roles: Proposed changes in Federal regulation of the financial industry

- 1 A new council composed of the Treasury Secretary and heads of seven other agencies would identify firms that could pose systemic risks and resolve jurisdictional disputes among agencies.
- 2 The Commodity Futures Trading Commission and SEC would have more authority to regulate derivatives.
- 3 Hedge fund advisers with assets under management over a given threshold would be required to register with the SEC and open their books to regulators.
- 4 The Federal Reserve would be given new powers to oversee any large financial entities whose failure could jeopardize the stability of the financial system.
- 5 The FDIC would have new authority to take over and shut down financial institutions whose failure could pose a systemic risk.
- 6 A new agency, the Consumer Financial Protection Agency, would set and enforce rules regarding consumer loans, like credit cards and mortgages.
- 7 The Office of the Comptroller of the Currency and the Office of Thrift Supervision would merge to become the new National Bank Supervisor, which would regulate all federally chartered depository institutions. Thrift Charters would be eliminated.
- 8 The Office of National Insurance will operate under 6 principles. It will identify insurance Tier 1 FHCs subject to Federal Reserve Supervision. Any insurance company owning an insured depository institution will also be subject to consolidated supervision.

- New
- Eliminated
- Current Role
- Expanded or New Role



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