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Post-Crisis Financial System Reform: Impact on the U.S. Insurance Industry in the Evolving Regulatory Landscape

Introduction

This Capital Markets Special Report recapitulates the impact on U.S. insurance companies of financial system reform—the widespread legislative and regulatory actions enacted around the world in response to the financial crisis and Great Recession—and, in particular, the federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). President-elect Donald Trump and many congressional Republicans, who will enjoy majorities in both houses, have vowed before and since the election to dismantle Dodd-Frank. The likely extent of the incoming administration's plans to repeal or alter Dodd-Frank is not yet known; this report simply provides a review of Dodd-Frank's multifaceted impact on the U.S. insurance industry, to help assess the potential ramifications of future changes for insurers and policyholders.

Dodd-Frank effected the most significant changes to U.S. financial regulation since the Roosevelt era, touching all federal financial regulatory agencies and almost every part of the U.S. financial services industry. While the work of developing regulations that meet the mandate of the legislation still is not complete, substantial progress has been made. This report discusses the still-developing impact on the U.S. insurance industry of this sweeping reform, both directly and indirectly, on the ways insurers invest, the savings and investment products they provide, and other activities they pursue, including their interaction with other financial institutions.

The Origin and Intent of Dodd-Frank and Related Reforms

In June 2009, in response to the financial crisis and Great Recession, President Barack Obama proposed a "sweeping overhaul of the U.S. financial regulatory system," with several key objectives: enacting robust supervision of financial firms by consolidating financial regulation and focusing on systemic risk; enacting comprehensive supervision of financial markets, with a focus on transparency and derivatives; protecting consumers and investors through a new federal agency and new product standards; providing the government with the tools it needs to manage financial crises, laying a path for the resolution and liquidation of troubled institutions with minimal taxpayer funds; and raising international regulatory standards and improving international cooperation.

Dodd-Frank itself included additional measures, most notably the so-called Volcker rule that limits banks' trading activities. The act is divided into 16 titles, but can be boiled down into six key areas:

1. Financial stability.
2. Orderly liquidation and resolution.
3. Expansion/transfer/consolidation of regulatory powers.
4. Improvements to, and expansion of, financial regulation.

5. Investor protection.
6. Mortgage reform.

Dodd-Frank is only one element in the vast patchwork of global financial system reform; similar efforts are underway in other jurisdictions. For example, since 2009, the Basel Committee on Banking Supervision has led the effort to revamp global banking regulations by enhancing required capital and liquidity levels, and the Financial Stability Board (FSB) has proposed additional requirements for banks' total loss absorption capacity.

Far-Reaching, Significant Impact

Given its sweeping nature, Dodd-Frank predictably has had a far-reaching and significant impact on the financial services sector, and regulators and companies alike are still adapting. According to Bloomberg News, Dodd-Frank has led regulators to create 274 rules that have been finalized, with another 36 proposed and another 80 that have yet to be proposed, some of which are past their due date. For financial institutions, compliance with the myriad regulatory changes has been daunting, at times confusing, and expensive; estimates for the law's total cost vary, but researchers following developments in this area estimate the costs to be as high as $40 billion, according to Bloomberg Markets. The U.S. Government Accountability Office (GAO) said in December that it is too early to calculate overall costs, but banks have reported increases in funding, compliance and capital costs. The GAO added that Dodd-Frank could have caused "moderate to minimal initial reductions in the availability of credit." Financial markets have been significantly affected; certain markets have experienced reductions in trading volume and liquidity as market making has scaled back. To be sure, the effects of Dodd-Frank and other reform measures have been most significant for banks, especially large global institutions, and broker-dealers, to a somewhat lesser extent, but the insurance industry also has been affected, directly and indirectly.

Direct Effects of Dodd-Frank on the U.S. Insurance Industry

Title V: The Federal Insurance Office and Limited Expansion of Federal Authority

Dodd-Frank Title V modestly expanded federal authority regarding the U.S. insurance industry. Subtitle A, also known as the Federal Insurance Office Act of 2010, created the Federal Insurance Office (FIO), a new arm of the U.S. Department of the Treasury. The FIO is not a regulatory agency, and its authorities do not displace the state-based insurance regulatory regime; its role is to monitor the U.S. insurance industry, identify gaps in regulation that could pose a risk to the financial system, help initiate orderly resolution (Title II) procedures for a company whose largest subsidiary is an insurer, and make recommendations to the Financial Stability Oversight Council (FSOC) about insurers that may pose a systemic risk. The FIO also advises the Treasury secretary on major domestic and prudential international insurance matters. The FIO, along with the Federal Reserve (Fed), the NAIC and its 56 member jurisdictions, has authority to represent the U.S. federal government internationally at meetings of the International Association of Insurance Supervisors (IAIS) and similar organizations.

One of the initial tasks assigned to the FIO by Dodd-Frank was to produce a report with recommendations on how to modernize and improve the regulation of insurance in the U.S. In its report, released in 2013, the FIO acknowledged many strengths and accomplishments of state-based insurance regulation, but also advocated complementary roles for state and federal regulators, with direct federal involvement in select circumstances. The report recommended a number of actions for the states, mostly involving greater uniformity among state laws and regulations—many of which the FIO acknowledges are already the states' initiatives in conjunction with the NAIC—and relatively little direct federal involvement. A report published in February 2016 by the GAO made similar recommendations, as have the International Monetary Fund and the FSB in recent years.

Title V: Covered Agreements and Federal Preemption

Most significantly, Title V authorizes the Treasury secretary and the Office of the U.S. Trade

Representative to enter into covered agreements, which are international agreements of mutual recognition regarding the prudential regulation of insurance or reinsurance. If they become effective, such covered agreements could preempt certain state laws and reduce or eliminate reinsurance collateral requirements for foreign reinsurers. The FIO and USTR has concluded negotiations with the EU over a Covered Agreement, and on January 13, 2017, Treasury and USTR sent letters to four congressional committees informing them that covered agreement negotiations have been completed.

Under Dodd-Frank, covered agreements are limited to prudential matters. Within that scope, a state insurance measure can only be preempted if the FIO director determines that: 1) the measure results in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. insurer domiciled, licensed or admitted to do business in that state; and 2) the measure is inconsistent with a covered agreement. In addition, any preemption must "achieve a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation." The NAIC *Credit for Reinsurance Model Law* (#785) and the *Credit for Reinsurance Model Regulation* (#786) were revised in 2011 to significantly reduce reinsurance collateral requirements—from 100% to as little as 10% of reinsurance liabilities—for certified reinsurers that are licensed and domiciled in qualified jurisdictions. As of Sept. 2, 2016, 35 states—representing more than two-thirds of direct U.S. premiums—have adopted one or both of the revised Model #785 and Model #786. As of Jan. 1, 2016, Bermuda, France, Germany, Ireland, Japan, Switzerland and the U.K. were designated as qualified jurisdictions.

A thorough discussion of the completed covered agreement and its terms is beyond the scope of this special report. Note, however, that the agreement can initially only be provisionally applied, and no U.S. state laws can be preempted until such preemption determinations are made. The ultimate outcome of the covered agreement implementation initiative, any ensuing litigation and the process for Model #785 and Model #786 to become an accreditation standard all are yet to be determined, and will depend on the interplay between the many interested parties.

Title I and Title XI: A New Federal Regulator and a Larger Role for the Fed

Title I, also known as the Financial Stability Act of 2010, created two new agencies tasked with monitoring systemic risk and the state of the economy, and clarified the supervision of bank holding companies. FSOC, a 15-member body chaired by the Treasury secretary, was created to identify threats to U.S. financial stability, promote market discipline and respond to emerging risks. FSOC has the power to designate bank holding companies and nonbank financial companies as posing a risk to the financial stability of the U.S., placing the consolidated entities under the supervision of the Fed.

Title XI addresses governance and oversight at the Fed. More important, the Fed was directed to establish enhanced prudential standards, including leverage and risk-based capital (RBC) standards and stress-testing requirements, for the institutions they supervise. The Fed has required the largest U.S. bank holding companies to submit annual capital plans demonstrating their ability to meet required capital ratios under baseline and stressed conditions, and has adopted liquidity coverage and supplemental leverage ratio requirements for U.S. global systemically important banks (G-SIBs). Some requirements have been proposed for designated nonbank financial companies that are predominantly insurers; Dodd-Frank allows the Fed to tailor its approach, and the Fed intends to assess the business model, capital structure and risk profile of designated non-bank companies to determine how enhanced prudential standards should apply to them. In addition, the Fed may exclude certain insurance activities from consolidated minimum leverage and capital requirements and minimum RBC requirements.

On June 3, 2016, the Fed issued an advance notice of proposed rulemaking (ANPR) inviting comment on a conceptual approach to capital standards for systemically important insurance groups, which would apply to the two systemically important insurance groups currently under Fed supervision. Known as the consolidated approach, it would assign each of an insurance firm's assets, liabilities and certain off-balance sheet exposures to risk segments that share similar risk characteristics. Then, each risk segment would be weighted by a risk factor, and the factor-weighted exposures would be summed to arrive at a consolidated required capital amount. Finally, the insurance group would calculate its consolidated "qualifying capital" and compare it to required capital, making sure it meets any applicable minimum capital ratios. Still to be determined are how exposures are to be segmented, how exposures should be measured, how risk weightings should be determined, a definition of "qualifying capital" and the criteria that should be used to determine a minimum capital ratio. Enhanced prudential and capital standards imposed on an insurance systemically important financial institution (SIFI) could adversely affect its ability to pay dividends or engage in other transactions that could affect its capital.

The ANPR could affect the NAIC's ongoing efforts to develop a U.S. group capital calculation, which already reflects a complex interplay between state, federal and international regulators, whose goals and assumptions may not be completely consistent. Such differences have unique implications in the U.S., where state-based insurance regulation's legal entity requirements can prevent monies from being treated as fungible within a group. However, the Fed's proposed approaches to capital should assuage some industry concerns. Notably, the Fed rejected approaches that applied existing bank capital rules, excluded insurance operations, applied internal stress testing or were based on the EU's Solvency II regime. The Fed also appears to have rejected the market-adjusted valuation approach, which is one of two proposed accounting models by the IAIS in developing its risk-based global insurance capital standard (ICS), a group-wide, consolidated ICS for internationally active insurance groups (IAIGs) and global systemically important insurers (G-SIIs) that is expected to be finalized by 2019 as part of the IAIS' Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame).

Dodd-Frank requires that non-bank SIFIs provide to the Fed and the Federal Deposit Insurance Corporation (FDIC) an annual (or more frequent) plan for rapid, orderly resolution in the event of material financial distress or failure, which must include a detailed resolution strategy and an analysis of its material entities, organizational structure, interconnections and interdependencies, and management information systems. The Fed also is required to prescribe regulations for "early remediation" of distressed non-bank SIFIs, whereby failure to meet defined measures (including regulatory capital, liquidity or other forward-looking indicators) would result in intensifying remedial action such as capital raises, limits on transactions with affiliates, management changes or asset sales.

Dodd-Frank also requires the Fed to promulgate regulations that would prohibit non-bank SIFIs from having a net credit exposure to any unaffiliated company in excess of 25% of its capital stock and surplus. Credit exposure includes all repurchase agreements, reverse repurchase agreements, securities borrowing and lending transactions with an entity; all guarantees, acceptances or letters of credit; investments in securities issued by an entity; derivatives counterparty credit exposure; and other similar transactions.

International and Global Initiatives

In addition to Dodd-Frank in the U.S., policymakers around the world are taking similar steps to prevent future financial crises. Much of this work is being led by the FSB, which is composed of representatives from the G-20 nations (U.S. state insurance regulators are not represented). The G-20, the FSB and related authorities have developed proposals to address financial group supervision, capital and solvency standards, systemic risk, corporate governance and other related issues.

Many expect the U.S. to take into consideration organizations identified by the FSB as G-SIIs in its determination of SIFIs. The IAIS, at the direction of the FSB, is developing capital standards that address the systemic and moral hazard risks posed by G-SIIs, with the goal that each G-SII has additional or higher loss absorbency (HLA) over the capacity implied by its existing group capital requirements. To address the need for a common base across G-SIIs domiciled in different jurisdictions, the IAIS developed a basic capital requirement (BCR), a baseline capital metric calculated by applying factors to exposures for insurance risk and asset risk, plus any additional capital requirements for non-insurance business, which was approved by the FSB and the G-20 in November 2014. The HLA standard, approved in November 2015, establishes an additional capital buffer, whereby an insurer is placed in one of three risk buckets, based on its G-SII designation score, that determines the factors used in a second factor-based calculation. The insurer's total qualifying capital is then compared to the sum of BCR and HLA required capital. Beginning in 2019, G-SIIs will be expected to hold regulatory capital that is not less than the sum of the BCR and the HLA requirements. These requirements apply to all group activities, including non-insurance subsidiaries. The IAIS does not have direct authority to require G-SIIs to comply with the BCR and the HLA standards, but if they are adopted by group supervisory authorities in the U.S., U.S.-based G-SIIs could become subject to these standards. As noted previously, the IAIS is now developing a risk-based, group-wide, global ICS for internationally active insurance groups (IAIGs), which is intended to replace the BCR as the base upon which the HLA is added.

The developments listed above—and other international initiatives, such as ComFrame and Solvency II—could impact the ways in which certain large, internationally active insurers deploy capital within and across entities (including non-insurance entities), structure and manage their businesses, and otherwise operate within the U.S. and abroad. As lawmakers and regulators in multiple jurisdictions simultaneously pursue these initiatives, there is potential for inconsistent and conflicting regulation. Overly stringent or duplicative capital requirements could restrict payments within a group or to third parties intended to fund firm obligations or dividends.

Title II: Resolution

In Title II,Dodd-Frank expanded existing federal laws that handle the liquidation and receivership of federally regulated banks, depository institutions insured by the FDIC and broker-dealers insured by the Securities Investor Protection Corporation (SIPC) to potentially cover non-bank financial companies. Depending on the type of financial institution, different regulatory organizations may jointly or independently, by two-thirds vote, recommend to the Secretary of the Treasury whether a receiver should be appointed for a financial company; for insurance companies, the FIO and the Fed make the recommendation. A financial company whose largest U.S. subsidiary is an insurer also may be subject to the Title II resolution process outside the bankruptcy code—to be administered by the FDIC upon a determination of the Treasury Department, in consultation with the U.S. president, on the recommendation of the FIO director and the Fed—that it is in default or in danger of default, is unlikely to attract private sector relief and is not suitable for resolution under the bankruptcy code. While under this new regime, insurance operating companies would continue to be resolved in accordance with state insurance laws, if the FDIC were appointed as the receiver for another type of a company (including an insurance holding company), liquidation of that company would occur under the new liquidation authority. In such a case, certain of that company's creditors could potentially be treated differently than under the bankruptcy code, and unsecured creditors and shareholders could bear the losses of the company being liquidated; this provision has potentially adverse implications for investors that hold affected securities in their investment portfolios, threatening their position as creditors and the value of such holdings.

Title III: Changes to the Regulation of Thrifts

Even before the enactment of the federal Gramm-Leach-Bliley Act of 1999, which repealed part of the Glass-Steagall Act of 1933 and allowed bank and non-bank institutions to combine and compete across the financial services arena, a number of insurance companies entered the banking industry by establishing thrifts—savings and loan institutions chartered by the Office of Thrift Supervision (OTS)—that would allow them to better compete with banks that were increasingly marketing insurance products through their branch networks. In addition, a handful of insurance companies obtained financial holding company status that allowed them to engage in banking activities. Dodd-Frank Title III, also called the Enhancing Financial Institution Safety and Soundness Act of 2010, streamlined banking regulation by abolishing the OTS and transferring its powers to the Fed for thrift holding companies, to the FDIC for state savings associations and to the Office of the Comptroller of the Currency for other thrifts.

The Fed initially listed 20 insurers with thrifts for additional oversight as thrift holding companies. Many subsequently shed their thrift units to avoid the ensuing additional layer of federal regulation, including stress tests, while others sold their stakes in thrifts, or sold their FDIC-insured deposits and downgraded their charters to trust banks, which are barred from most traditional banking activities. Similarly, at least one insurer changed its thrift charter to a credit union charter.

Separate from the proposed capital rules for SIFIs discussed earlier, for the 12 remaining Fed-supervised insurance holding companies that own a bank or thrift, the Fed, in its ANPR dated June 3, 2016, proposed a so-called building block approach (BBA) to capital requirements. Under the BBA, qualifying capital and required capital would first be calculated at the legal entity level. For example, capital requirements for regulated insurance subsidiaries would be determined according to the rules of the appropriate state or foreign insurance regulator, and qualifying capital and required capital for each insured depository institution or other legal entity would be determined according to any relevant capital rules that would apply. This is similar to the RBC aggregation approach for the NAIC group capital calculation currently being developed. The Fed is seeking comments on how to determine appropriate baseline or minimum capital levels, so the ramifications for affected companies are uncertain.

Title IV: Asset Management Regulation
Insurance companies often have asset management operations that provide investment management and other services. Some insurance companies have had extensive asset management operations for some time, while others have acquired asset managers in recent years, in order to grow their businesses. These asset management activities, which are distinct from on-balance sheet insurance-related investment activities that are exempt from registration, now may be subject to more federal oversight. Title IV expanded the regulatory umbrella into new territory, by requiring certain previously exempt investment advisors—including many hedge fund and private equity fund managers—to register under the federal Investment Advisers Act of 1940. The reporting requirements for investment advisers were also increased, and opportunities were reduced for advisers to exclude information from reports to regulators. In addition, a new U.S. Securities and Exchange Commission (SEC) rule that requires private fund advisers to periodically file Form PF, on which they report regulatory assets under management (RAUM) to FSOC so it can compile risk exposure statistics on the type and size of assets held by private fund firms. Advisers with at least $150 million under management must periodically file Form PF. Large advisers are required to report more information more frequently. The U.S. Congress is considering whether to increase the frequency of examinations of SEC-registered investment advisers, and authorizing one or more self-regulatory organizations to examine, subject to SEC oversight, SEC-registered investment advisers.

On Dec. 11, 2015, the SEC approved a proposed rule intended to enhance investor protection by limiting the use of derivatives by mutual funds, closed-end funds and exchange-traded funds (ETFs), and requiring new risk management measures with respect to derivatives. The timing of the final rules and implementation time frames are unclear, however.

Title IX: Investor Protection and Broker-Dealers
Title IX, the Investor Protection and Securities Reform Act of 2010, revamped the powers and structure of the SEC, and enhanced federal regulatory powers in several areas. Subtitle A created the Office of the Investor Advocate and an ombudsman appointed by that office, and formally authorized the Investor Advisory Committee created in 2009. This subtitle also authorized the SEC to create "point of sale

disclosure rules" for retail investors covering costs, risks and conflicts of interest, and authorized the SEC to impose a fiduciary duty standard on broker-dealers (distinct from the final rule issued in April 2016 by the U.S. Department of Labor concerning retirement plan-related investment advice). In January 2011, the SEC recommended to Congress a fiduciary standard for broker-dealers and investment advisers when they provide investment advice about securities to individual investors. The prospect of a uniform fiduciary standard was concerning for life insurers with captive distribution channels, as they would potentially face increased training, oversight and compliance costs, and possibly lose sales if suitability requirements were made more stringent. In recent years, a number of insurance companies have jettisoned their independent broker-dealers whose margins have been squeezed in part due to rising compliance expense and risk, as well as added regulatory pressure associated with proprietary products. Subject to SEC approval, the Personalized Investment Advice Standard of Conduct rule is scheduled to be posted by April of 2017, which is when the Department of Labor's final fiduciary rule is scheduled to take effect.

Indirect Effects

Title VI: the Volcker Rule, Title IX: New Bank Capital Requirements, and Market Liquidity

Title VI, also known as the Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010, introduced the so-called Volcker rule—named after former Fed Chairman Paul Volcker—an amendment to the federal Bank Holding Company Act of 1956 intended to reduce the exposure of large financial institutions to speculative investments. Under the rule, banking entities with trading assets and liabilities of at least $50 billion are all but prohibited from proprietary trading (trading for their own account), with the exception of Treasury securities, federal agency-backed bonds and municipal debt, although banks' securities underwriting, market making and related hedging activities are exempted from the rule as long as a trading desk's position does not exceed the "reasonably expected near term demand" of customers. Nonbank financial companies supervised by the Fed that engage in proprietary trading or hold interests in a hedge fund or a private equity fund shall be subject to additional capital requirements for and additional quantitative limits with regards to such activities, except for permitted activities that include trading for an insurer's general account.

For insurance companies, the most significant, albeit indirect, effect of the Volcker rule—along with heightened capital requirements for the largest banking organizations under Dodd-Frank and the Basel accords—is the reduction in market liquidity that has frequently been reported in recent years, particularly in corporate bonds, which are a staple of insurers' investment portfolios. According to the *2015 Global Insurance Market Report* published by the IAIS, life insurance companies are estimated to hold 20% of the corporate bonds in the U.S., 21% in Europe and 40% in Japan. Insurance companies typically are not active traders; they tend to purchase corporate bonds as new issues and hold them long-term, often to maturity. However, investment grade corporate bonds can be a source of funds for insurers that need to liquidate some invested assets to meet large claims or policy surrenders, provided that the market is able to provide that liquidity when needed. Market liquidity—the ability of buyers and sellers of securities to transact efficiently—can be measured by the speed with which blocks of securities can be bought and sold, and by transaction costs, which include both the explicit bid/ask spread and the market price changes that result from large bids or offers. Market liquidity, then, is linked to price volatility; transaction volumes cause bigger price movements when markets are illiquid.

The debate on market liquidity is multifaceted and somewhat contentious, but numerous market participants, including some insurance companies, have expressed concern about possible adverse impacts of regulatory initiatives on the liquidity of securities in which they invest, and federal regulators have chimed in on both sides of the debate. Many observers have cited the reduced risk appetite of dealers in this changing environment as a cause of declining market liquidity. Dealer corporate bond inventories fell sharply post-2008, and while the methodology for calculating dealer corporate bond inventories changed in April 2013 to exclude non-agency mortgage-backed securities—making newer data not directly comparable—the trend has continued downward since 2013. While some cite the rise in corporate bond issuance since 2008 as demonstration of the market's liquidity, others note that secondary trading volume has grown much more slowly than the amount of corporate bonds outstanding. The ratio of bond market turnover has *declined*, from about 80% in 2009 to just 60% in 2015.

At the same time, the structure of the fixed-income market has changed; the amount of assets managed by bond mutual funds has more than doubled since 2008, to more than $3.1 trillion, and the growth of bond ETFs has been even more explosive, increasing nearly six-fold since 2008, to $343 billion. The rise of these investor classes—which can behave differently than traditional fixed-income investors that often hold bonds to maturity—could place greater liquidity demands on markets than in the past, at a time when it may indeed be diminished. To some observers, this gives rise to a systemic risk of large-scale and correlated redemptions from open-end mutual funds, specifically that as accommodative monetary policies are unwound, the increased size of these funds could render them unable to meet mass redemptions, potentially leading to contagion. Regulators have shared this concern; in 2015, the SEC proposed a comprehensive set of rules under which mutual funds and ETFs would be required to implement liquidity risk-management programs and enhance disclosure regarding fund liquidity and redemption practices. In October 2016, however, the agency approved a softened rule that exempts ETFs that redeem in kind, providing securities rather than cash to meet redemptions, and provide daily portfolio information.

While concerns about systemic risk in mutual fund structures are valid, it is important to remember that liquidity is not free; obtaining liquidity from the market entails a cost that is reflected in transaction prices. When market participants demand immediate liquidity, the cost may be higher, particularly if immediacy is demanded when liquidity is scarce. In its *2015 Trading Desk Optimization Study,* Greenwich Associates reported that, out of 58 institutional fixed-income investors surveyed, 74% said it was either difficult or extremely difficult to execute trades of $15 million and over, compared to 81% a year earlier. Even more telling was the fact that 53% said trades of $5 million to $15 million were hard to execute, compared to 33% a year earlier, and 16% said even modest institutional trades of $1 million to $5 million were hard to execute, compared to just 6% in 2014. This data appears to corroborate observations in recent years of a reduction in average transaction size as investors break up large orders to facilitate execution, although innovations in trading strategy could explain some of the reduction.

With the additional restrictions, dealers increasingly favor agency trading (acting as broker between two counterparties) over principal trading (buying and selling out of inventory); however, trading costs rise as a result. This is especially true as bond issues become more seasoned and less "on-the-run."

Title VII: The Remaking of the Derivatives Market

Many of the largest insurance companies, especially in the life insurance sector, use derivatives to mitigate a wide range of risks, including the impact of increased exposures from products that offer guaranteed benefits. The primary use of derivatives among insurers is for hedging, chiefly with respect to interest rate risk and equity risk. When hedging interest rate risk, insurers tended to favor interest rate swaps as their principal tool, followed by options (including swaptions, caps and floors). For a more detailed discussion of the effect of regulatory developments on the means by which insurers hedge risk, as well as the potentially rising cost of hedging, please refer to the NAIC Capital Markets Bureau's Special Report titled, "Developments in the Derivatives Markets with Respect to Hedging Costs and Practices in the U.S. Insurance Industry," published Aug. 26, 2015.

Title VII, the Wall Street Transparency and Accountability Act of 2010, expands the regulation of swaps—including interest rate swaps, credit default swaps and other credit derivatives—in several ways. First and foremost, Title VII takes aim at *over-the-counter (OTC) derivatives,* which are privately negotiated, ranging from highly customized, complex contracts with long maturities to more standardized, shorter-dated, somewhat liquid instruments. Historically, OTC derivatives were bilateral contracts booked directly between counterparties, giving rise to counterparty risk. A principal goal of Dodd-Frank was to reduce systemic risk by pushing as much of the derivatives market as possible toward a new model where counterparty risk is pooled at eligible central counterparty clearinghouses (CCPs) known as derivatives clearing organizations (DCOs). In addition, in order to make derivatives markets more transparent, Dodd-Frank mandates that all standardized, liquid instruments subject to central clearing eventually must trade on electronic exchanges. Trades must be reported to data repositories, with price and volume data made public.

The framework for the regulation of swaps imposes reporting and margin requirements, and possibly additional capital requirements; therefore, the costs of risk management are increasing. While margin requirements for OTC derivatives have varied, Dodd-Frank requires that initial and variation margins be standardized, phasing these requirements in over time from 2016 to 2020. The effectiveness of hedging programs may also be affected, as the new regulatory framework favors standardized futures and exchange-traded swaps contracts. Bilateral contracts allow the counterparties to custom tailor derivatives to meet specific needs.

Asset-Backed Securities

Title IX, Subtitle D requires changes to the asset-backed securitization process, most notably the new risk retention requirement for asset backed securities (ABS). The final rule requires sponsors of ABS to retain at least 5% of the credit risk of each pool of assets underlying the securities, and prohibits sponsors from transferring or hedging that credit risk during a specified period. The final rule already applies to ABS backed by residential mortgages; it applies to all other classes of ABS issued on or after Dec. 24, 2016. Securitizations of qualified residential mortgages—loans that meet the Consumer Financial Protection Bureau's qualified mortgage (QM) definition—are exempt from the risk retention rule. While the rationale for requiring greater risk retention is clear in light of the role ABS issuers played in precipitating the financial crisis, some issuers of non-QM backed ABS may not have sufficient capital to adhere to the 5% rule, and industry participants may push regulators for clarifications and amendments to the rule. Some, therefore, fear that the rule will boost issuance and borrowing costs, and that some sponsors may exit the market.

As such changes in regulatory oversight have changed the economics of securitization, institutions—banks, insurance companies and other asset managers—are more incented to retain assets instead of selling them into the securitization market, thus constraining their ability to make new loans. This creates a potential competitive advantage for insurance companies as investors; an example is commercial real estate mortgages, where life insurers have had a long and successful investment track record. While holdings of non-agency commercial mortgage-backed securities (CMBS) within the U.S. insurance industry have been declining as a percentage of invested assets, investment in commercial real estate mortgages has grown from $297 billion in 2010 (5.8% of invested assets) to $387 billion in 2015 (7.0% of invested assets).

Conclusion

Financial system reform has had direct consequences through changes to U.S. and international regulation, and indirect effects on the ways insurers invest, the savings and investment products they provide, and other business activities they pursue. The impact of these sweeping, complex and often costly reforms are not yet fully realized, and are likely to continue to change as a new administration takes over in Washington, DC.

A dismantling of Dodd-Frank would be extremely complicated and lengthy. While some Dodd-Frank regulations could be amended or rescinded through rulemakings, such actions would require a change in leadership at the agencies, which will take some time. Agency officials will have to decide which

Dodd-Frank rules and regulations can be amended or undone, and in what order such changes should take place, with an understanding of the implications of doing away with them. Wholesale reform could only be done through legislation and legislative changes may be difficult, given the narrow Republican majority in the U.S. Senate. Further, financial services industry leaders, such as JPMorgan Chase CEO James Dimon, have cautioned that they do not want a wholesale repeal of Dodd-Frank, given that they have spent six years and hundreds of millions of dollars adapting to financial services reform, shedding numerous businesses along the way. These institutions claim they are not looking to re-engage in activities such as proprietary trading, and they acknowledge the benefits of enhanced capital requirements; rather, these institutions favor changes that make regulation simpler and less costly, such as streamlining the stress-testing process and changing the administration of the Volcker rule to facilitate market making and improve liquidity.

The NAIC Capital Markets Bureau will continue to monitor developments in financial system reform and publish additional research as deemed appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.