Thinking About Insurance Capital

A Public Interest Perspective

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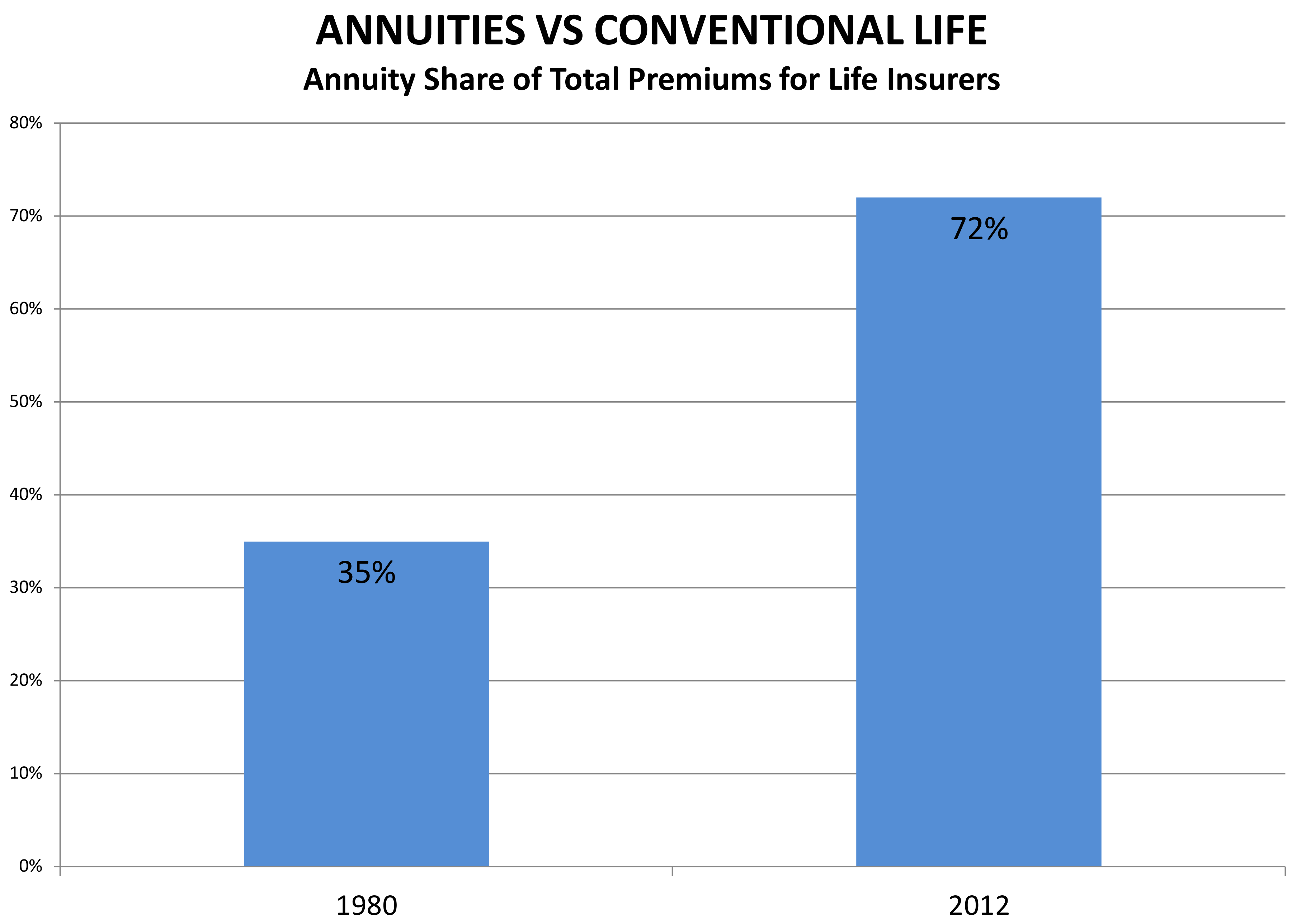
‘Conventional’ Insurance

- Diversified risk pooling.
- Risky events uncorrelated with financial sector.
- Clients cannot easily cash out on demand.
- Property and casualty, conventional life.

Financial Guaranty and Investment Products

- Concentrate financial risk with the insurer. Not a diversified pool of event-based risk.
- Institutional and fund products: GICs, wraps, bond insurance, etc.
- Individual products: variable annuities, contingent deferred annuities. Many annuities accessible on demand.


ANNUITIES VS CONVENTIONAL LIFE
Annuity Share of Total Premiums for Life Insurers
80%
70%
60%
50%
40%
30%
20%
10%
0%
35%
72%
1980
2012

Insurers as Asset Holders

- Insurers collectively own about a third of investment-grade bonds.
- This implies potentially significant impacts when insurers must liquidate large amounts of assets.
- Insurers hold many illiquid assets – appropriate <u>if</u> liabilities are reliably long-dated and diversified.
- Potential to become dealer-like intermediaries through securities lending.

Some Lessons of Crisis

- AIG was unique, but the <u>lessons</u> of AIG – the ease with which a large insurer was able support a financial guaranty subsidiary with major impacts across the system -- are much broader and still hold.

- Monoline insurers, mortgage insurance show risks of undercapitalized direct financial guarantees.

- We need:
  - Appropriate group-level oversight.
  - No inappropriate arbitrage of risk.
  - To reexamine protection of policy holders.

The Response?

An alphabet soup of initiatives

- In the U.S. –
  - NAIC changes to state-based capital regulation
  - New FIO -- Federal advisory oversight for insurance
  - FSOC designating insurance SIFIs
  - Federal Reserve supervises insurance SIFIs, insurance BHCs
- Globally –
  - IAIS developing BCS and HLA requirements for G-SIIs
  - IAIS also developing risk-based ICS for IAIGs
  - FSB is supporting global regulatory effort

Some Commonalities

- All parties claim to recognize the difference between ‘non-traditional’ and ‘traditional’ insurance activities.
- All claim that they will tailor regulation to these differences.
- International regulators and FSOC agree on the importance of group-wide regulation.

Basel II for The Insurance Industry?

- Will this process turn into a black hole?
  - Endless fine-tuning of risk adjustments distracts regulatory resources, extends for many years?

- The danger of a mechanistic reliance on risk based capital.

- At the same time, if properly conducted the process should force attention to the full range of insurance activities, their systemic connections, and to group structure.

A Broader Framework

1. Product Regulation
2. Firewalling and company structure
3. Recovery and Resolution.
4. Capital and reserves.

Product Regulation

- Poorly designed financial guaranty products induce risk-taking, permit inappropriate arbitrage, and make commitments that cannot be kept in a systemic event.
- Capital regulation is an effective tool to restrict inappropriate financial guaranties, but it can be easier to directly police product design.
- Consumer protection, investor protection, and systemic risk have a strong connection.

Firewalling And Company Structure

- Real firewalls can fundamentally alter needs for capital and reserves.

- But AIG case shows that something was very strange about investor belief in legal firewalls.

- Effective firewalling requires active informing of investors, clear resolution priorities.

Recovery and Resolution

- A capital and reserve framework requires a clear sense of who will be permitted to take losses and how liquidity will be provided when a company faces financial distress.

- State guarantee funds are not pre-funded, limiting their use for liquidity purposes, and there appear to be significant questions about their capacity to protect policyholders in a systemic crisis.

Capital and Reserves

- Capital and reserves clearly have a critical prudential role to play, and are a key tool for all of the previous areas of concern.

- We will be assessing capital regulation in light of how well and how clearly it addresses the lessons of the crisis.