2009 Winter National Meeting
San Francisco, CA

Systemic Risk Panel/Solvency Symposium

December 3, 2009
1 p.m.

Meeting Summary Report

The Center for Insurance Policy and Research hosted a symposium on systemic risk on Dec. 3, 2009. During the symposium, a panel of experts discussed aspects of systemic risk in insurance and its regulation.

Dr. Ray Spudeck, Chief Economist for the Florida Office of Insurance Regulation, began his presentation by describing the evolution of the definition of systemic risk. At the request of the G20, the Financial Stability Board (FSB), the International Monetary Fund (IMF), and the Bank for International Settlements (BIS) developed guidance for national authorities to assess the systemic importance of financial institutions, markets and instruments in a report titled "Initial Considerations," published in October 2009. The report developed a definition for systemic risk and identified three characteristics to assess systemic importance: size, suitability and interconnectedness. Dr. Spudeck described recent activity conducted by the International Association of Insurance Supervisors (IAIS) including that of subcommittees looking at macroprudential tools, macroprudential surveillance and systemically important financial institutions.

Dr. Spudeck stated his belief that though the insurance sector is probably not a natural generator of systemic risk, insurance does seem to be one of the largest natural transmission pathways for systemic risk. He stressed that U.S. insurance regulators need to be a part of the international discussion in order to avoid bad policy.

Dr. J. David Cummins of Temple University began his presentation by defining systemic risk as a financial crisis in which many institutions become financially distressed, with a potential impact on real economic activity. He stressed that financial distress does not necessarily mean systemic risk. Institutions that pose significant systemic risk are often viewed as "too big to fail," meaning a failure would cause ripple effects throughout the economy due to the sheer size of the firms. Other institutions that may be systemically risky are those "too interconnected to fail," meaning firms with multiple counterparty relationships that could trigger a cascading chain of failures throughout the economy. In terms of insurer insolvency posing systemic risk to the economy, Dr. Cummins noted that insurer assets are only about 8% of total U.S. financial assets and U.S. regulated insurance companies are highly solvent. Life insurers may be over-leveraged and more interconnected than property-casualty insurers.

Dr. Cummins provided an overview of what led to the demise and bailout of AIG. Problems identified were credit default swaps within AIG's Financial Products unit of which insurance regulators did not have jurisdiction and the securities lending program of life insurance subsidiaries. Dr. Cummins noted that total U.S. life and property-casualty assessments from 1988 to 2007 amounted to $18 billion while federal assistance to AIG alone amounted to $136 billion.

Dr. Cummins concluded that property-casualty insurance does not create a systemic risk. "Runs" on insurers are not possible because policyholders must have a claim to obtain funds. The inter-sector exposure among insurers and between insurers and reinsurers is not sufficiently large to cause cascading failures. Insurers are not involved in liquidity creation and hold only a small proportion of total invested assets in the economy. Dr. Cummins concluded that life insurance is more likely to be systemically risky because insurers could be susceptible to "runs" in the form of withdrawals and/or the suspension of premium payments and annuity considerations; life insurers are thinly capitalized; the insurance guaranty fund system is probably not adequate for a major run or liquidity crisis; and life insurers owned by banks could add to the fragility of the banking system. On the other hand, Dr. Cummins noted that life insurance may not be systemically risky because the life insurance sector is not involved in liquidity or credit creation; life insurers own a small proportion of stocks and bonds in the economy; life insurance is a small proportion of household financial assets; life insurers are not major employers; and the disappearance of the entire sector would be sustainable.

Dr. Cummins stated his belief that the main systemic risk posed by the insurance industry comes from insurer participation in banking activities, including credit default swaps (CDS) and other derivatives. Because of this, Dr. Cummins believes that insurance groups should not be permitted to conduct credit default swap operations; credit default swaps should trade through a central clearinghouse in order to reduce counterparty risk; and CDS writers should be required to hold adequate capital.

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Dr. Cummins detailed several systemic threats to the insurance industry, including insurers conducting high risk derivatives operations out of non-insurance subsidiaries; insurers investing in risky or inaccurately rated structured securities; and major catastrophes.

Commissioner Thomas Sullivan of the Connecticut Insurance Department described contributors to the recent financial crisis. Among the causes he identified as creating imbalances in the financial system were U.S. monetary policy; excessive money creation; negative household savings; the U.S. trade deficit; dollar volatility; public deficits; inflation; and easy credit conditions. Commissioner Sullivan also detailed issues leading to the housing crisis, including Fannie Mae and Freddie Mac expanding risky lending; the SEC's relaxing of the net capital rule; investment banks increasing their leverage; and expanded issuance of mortgage-backed securities.

Commissioner Sullivan described inadequate regulation that existed in the financial industry due to the Gramm-Leach-Bliley Act; the SEC's relaxing of the net capital rule; deficient regulation of investment banks and hedge funds; off-balance sheet accounting; and the unregulated derivatives market. Commissioner Sullivan detailed Federal proposals concerning regulation of the financial industry, including a side-by-side comparison of the Senate and House bill's provisions concerning systemic risk, consolidated regulators, breaking up of risky funds, resolution authority, and the Consumer Financial Protection Agency.

Commissioner Sullivan explained some state regulator concerns over possible Federal regulation. These had to do with broad federal discretion over more than just banks and financial institutions; no punishment of excessive risk taking; and no provision for firms to be liquidated.

Dr. Spudeck presented on the topic of group supervision on behalf of Director Ann Frohman of the Nebraska Department of Insurance. Dr. Spudeck explained the differences between the functional regulator model used by the U.S. and the integrated supervisor model seen internationally. For the most part, U.S. insurance regulation has worked very well by focusing on the legal entity with additional analysis of group structures and relationships. The NAIC has created the Group Solvency Issues (EX) Working Group under the Solvency Modernization Initiative Task Force. The goal of looking at groups is to achieve better supervision across sectors for U.S. based conglomerates to contribute to sound insurance markets, improved management of group-wide risk and enhanced policyholder protection. The Working Group is looking at ways to effectively coordinate and communicate with other regulators and supervisors across sectors and jurisdictions; improve the use of Supervisory Colleges with regulators from around the world; and make enhancements to the Insurance Holding Company System Regulatory Act and Model Regulation.

A question and answer session was held following the presentations. In response to a question concerning whether reinsurers could pose systemic risk, Dr. Spudeck stated that a failure could cause disruption but would not likely create systemic risk. Dr. Cummins explained that there is not sufficient interconnectedness among reinsurers to create systemic risk. He did note that there may be danger due to the degree to which reinsurers are involved in credit default swaps. A participant asked whether the NAIC had an opinion on proposed Federal resolution authority to prefund a financial assessment on institutions. Commissioner Sullivan stated that the NAIC has not taken a position on this aspect but he noted that the House bill has a pre-event assessment while the Senate version has a post-event assessment. A question was posed concerning solvency regulation in the European Union, particularly Solvency II. Dr. Cummins stated that he believes insurance regulators need standardized models in order to evaluate and benchmark insurers' internal models. He noted that there is a natural tendency for insurers' internal models to create moral hazard.

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