Workshop on Systemic Risk in Insurance: Understanding FSOC Designation of Systemically Significant Insurers

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Overview

• (1) Uncertainty and change in systemic risk and insurance
• (2) State-based insurance regulation and systemic risk
• (3) SIFI designation under Dodd-Frank
(1) Uncertainty and change in systemic risk and insurance: Evidence

• A. AIG’s securities lending activities.
• B. Non-AIG insurance bailouts
  – Failure of financial guarantee insurers and auction-rate securities market.
• C. Quantitative measures of systemic risk of insurers, such as SRISK
(1) Uncertainty and change in systemic risk and insurance: structural vulnerabilities

• A. Plausible “transmission mechanisms”
  – (i) asset fire sales
  – (ii) Interconnectedness.

• B. Various insurance products include substantial optionality.
  – Deferred annuities, GICs, certain life insurance products

• C. Increasing capital markets activities
  – fragile capital market funding, catastrophe bonds

• D. Guarantee funds designed for policyholder protection, not systemic risk.
(1) Uncertainty and change in systemic risk and insurance: Potential Emerging Systemic Risks

• A. Principles-Based Reserving (PBR)
  – Similar to Basel II framework permitting banks to set capital levels using internal models.

• B. “Shadow insurance”
  – Creates recapture risk, correlated parent company risk, and increased interconnectedness
  – Increases opacity and complexity of industry
(2) State-Based Insurance Regulation and Systemic Risk

- Effective regulation of systemic risk requires consolidated oversight of complex conglomerates.
- State insurance regulation is almost entirely focused on individual legal entities.
- State group insurance regulation is entirely based on qualitative standards that are highly enforcement-sensitive.
- States have poor incentives and expertise when it comes to group-focused risk.
(2) State-Based Insurance Regulation and Systemic Risk
AIG and Securities Lending

AIG Holding Company

AIG Insurer 1 (domesticated in Penn)
AIG Insurer 2 (domesticated in Texas)
AIG Insurer 3 (domesticated in NY)

AIG Financial products

Credit Default Swaps (CDS)

Cash

Non-AIG CDS purchasers insuring against risk from risky mortgage relates securities

Non-AIG securities Borrowers

Securities (primary assets of insurers)

Cash collateral

Securities

Mortgage backed securities

Cash Collateral From securities borrowers

Sellers of Risky Mortgage-Related Securities

AIG Securities Lending
Ceding Insurer permitted to take reserve credit and RBC adjustments in connection with reinsured policies.

Unauthorized reinsurer that is not licensed or accredited by ceding insurer’s regulator.

Parent company of ceding insurer and captive reinsurer.

Companies within same Insurance holding company.

Parent guarantees captive reinsurer’s obligations under LOC.

Third-party bank.

LOC guarantees reinsurance.

Letter of Credit secured.

Reinsurance premiums.

Insured Policies reinsured.

Unauthorized reinsurer that is not licensed or accredited by ceding insurer’s regulator.

(2) State-Based Insurance Regulation and Systemic Risk
Shadow Insurance with LOC backed by Parental Guarantee.
(3) SIFI designation under Dodd-Frank

• A. Uncertainty of systemic risk in insurance combined with limits of state insurance regulation can incentivize insurers to affirmatively seek out systemic risk.

• B. Malleability of FSOC Designation standard disincentivizes insurance companies from seeking out systemic risk.
  – Creates only limited uncertainty due to (i) quantitative screen, and (ii) tacit non-designation of most insurers.

• C. FSOC Designation standard incentivizes state regulators to affirmatively respond to emerging areas of concern.
  – Shadow insurance reforms and group capital project.