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

Daniel Schwarcz
Schwarcz@umn.edu
University of Minnesota Law School

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.

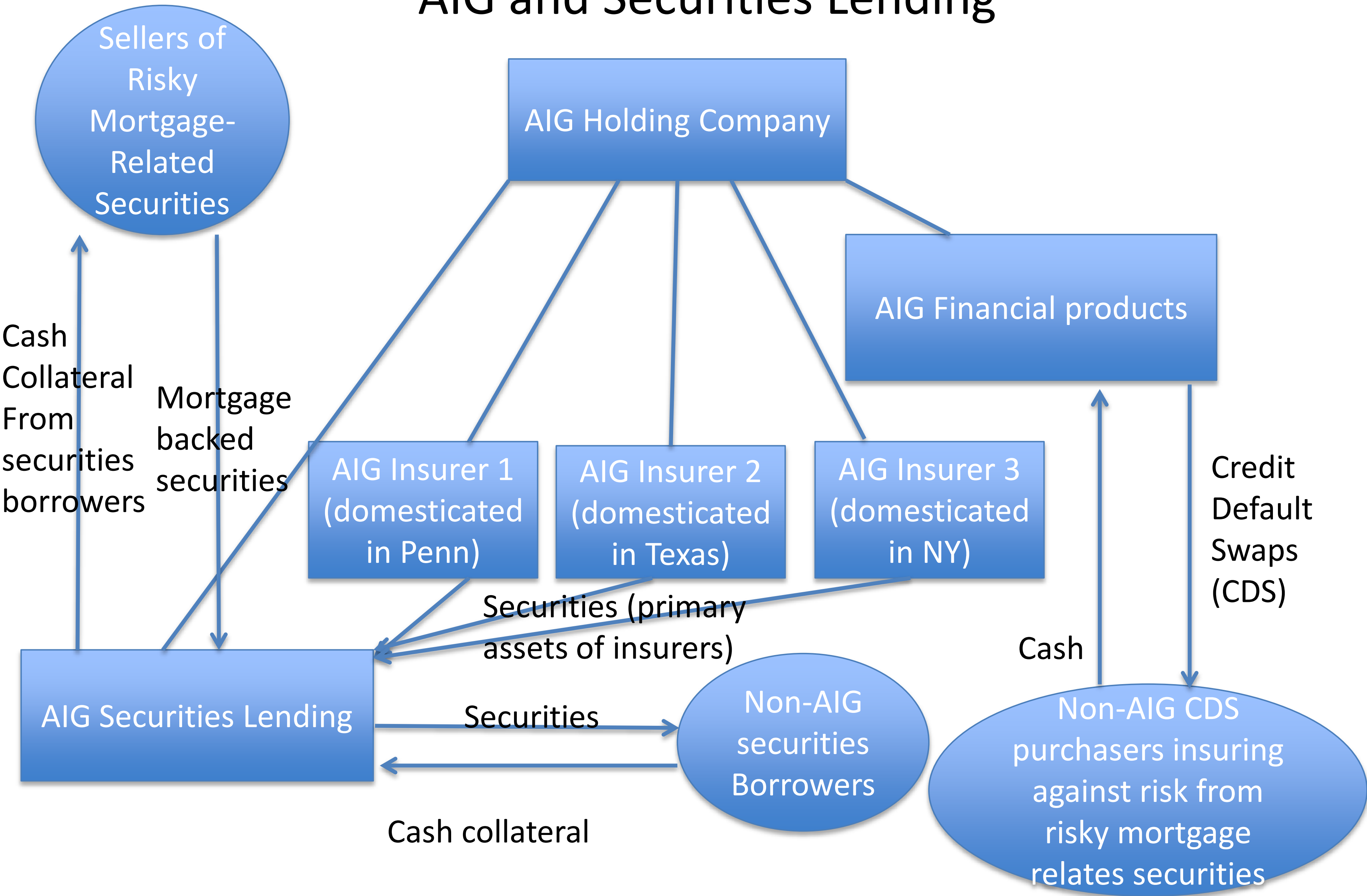
(1) Uncertainty and change in systemic risk and insurance: Potential Emerging Systemic Risks

- 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

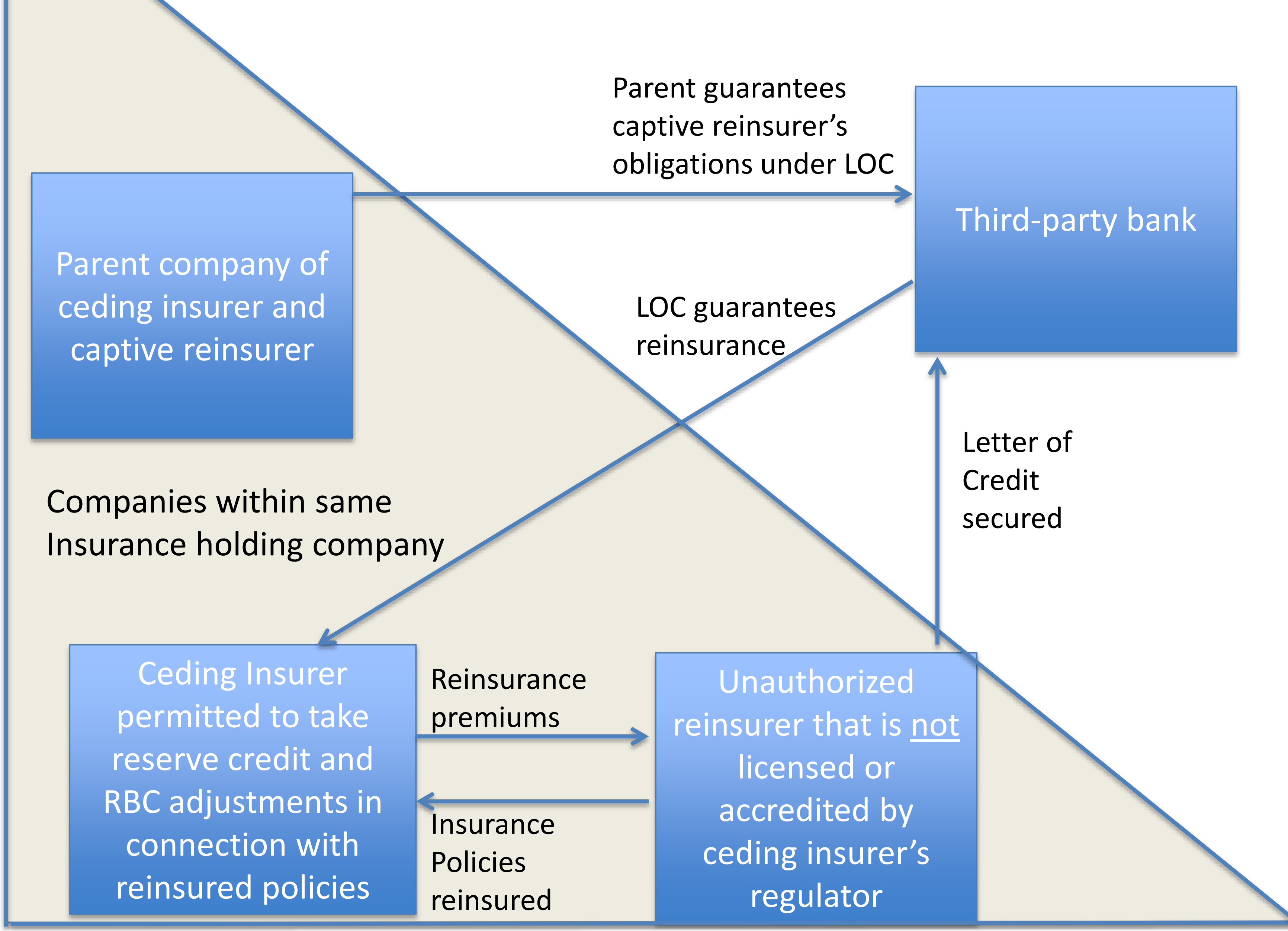
(2) State-Based Insurance Regulation and Systemic Risk

- 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



(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.