Changing Regulatory Landscape
Is Insurance Systemically Important?

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Introduction

The collapse of major financial service groups in 2008 and beyond rippled through the financial system and the economy, prompting the characterization of some organizations as "too big to fail." The Financial Stability Oversight Council (FSOC), headed by the US Treasury Secretary, is charged with classifying and identifying organizations that pose systemic risks. These organizations are known as Systemically Important Financial Institutions or SIFIs.

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In addition to certain large banks, which the Dodd-Frank Act of 2010 immediately designated as systemically important, SIFI designations were expanded to include nonbank financial companies and financial market utilities. FSOC also has designated certain producers of insurance services as important from a financial systems perspective.

SIFI designations for certain insurance institutions have resulted in criticism by insurance regulators and some in the insurance industry. Recently, and perhaps in response to criticism, FSOC has announced changes to its designation process, many of which address issues of transparency in FSOC's review and deliberations. However, the real issue may rest, not in creating greater transparency, but in the fact that the SIFI framework does not properly emphasize the critical element of run-prone liabilities applicable to any institution under FSOC consideration.

SIFI Framework

The current process for evaluating whether a company is systemically important requires FSOC members to consider, among others, at least eleven factors, "including the degree of reliance on short-term funding." The general framework for FSOC to determine a firm's likelihood to pose a threat to financial stability is not exhaustive and, admittedly, may not apply to all non-bank financial companies. These include the following:

Interconnectedness – direct or indirect linkages between financial companies that may be conduits for transmitting the effects of a nonbank financial company's material financial distress;

Substitutability – the extent other firms could provide similar financial services at similar price and quantity;

Size – the amount of financial services or intermediation the nonbank financial company provides;

Leverage – a company's risk exposure related to equity capital;

Liquidity Risk and Maturity Mismatch – the risk the company may not have sufficient funding for short term needs and differences in maturities between company assets and liabilities; and

Existing Regulatory Scrutiny – the extent and authority of regulatory oversight over nonbank financial companies, including consistency of regulation across the group's business sectors.

While it is at the end of a long list of considerations that Dodd-Frank spells out, an argument can be made that short term funding issues and maturity mismatch should carry more weight than (and perhaps override) other factors, particularly with regard to insurance company systems. Indeed, systemic crises may have a hard time starting without such run-prone liabilities.

The necessity of run-prone liabilities for posing a systemic risk

Insurance activities that may appear systemically important under Dodd-Frank's list of regulatory considerations can instead appear unimportant when evaluated in terms of reliance on run-prone liabilities.

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Financial organizations frequently engage in a process of maturity transformation, where long-term assets, like home mortgages, are funded by short-term liabilities, like demand deposits. The resulting mismatch in liquidity may expose financial organizations to "runs," that cause creditors to race to cash out before sales of less-liquid assets impair an organization's solvency. Conventional policies and regulations attempt to address this issue through publicly backed insurance of deposits and of capital adequacy standards. Despite these efforts, however, financial crises can persist, highlighting the possible need for alternative governance approaches.

One such strategy includes policies that discourage financial organizations from relying on run-prone liabilities. Debt contracts that promise lenders a fixed value upon maturity, and are on a first-come first-served basis, can be run-prone, and may be necessary for financial crises. This does not imply that crises are inevitable when short-term debt financing is present; rather, it suggests that such crises may be incapable of starting when such liabilities are largely absent.

Liabilities for insurers do not appear to be run-prone

Using this more focused consideration of systemic risk factors, enhanced oversight and regulation may have little room to increase financial stability when run-prone liabilities are largely absent from a company's balance sheet. Producers of narrow insurance services would normally appear to be largely immune from run-prone liabilities. For example, where claims on an insurer's assets are contingent on realizing perils like storm damage to a house, accident damage to a car, or death, an insurer's liabilities do not appear to be prone to runs.

Of course, there are possible run-prone issues if an insurer is non-diversified and concentrates on certain risks where a significant number of claims could arise simultaneously or close in time. This type of exposure is likely unusual for a nonbank financial group that could otherwise be deemed systemically important, especially in view of state regulatory oversight and required insurance reserving practices.

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Financial services organizations, which include banking, may fund a significant portion of their assets through interest bearing liabilities. Thus, a large portion of their liabilities may be customer deposits, which may be prone to runs. By comparison, a large producer of insurance services may maintain a capital structure that appears less run-prone. While a substantial percent of its assets may be funded by various debt obligations, a small percentage of these assets may receive financing through short-term debt.

This type of difference in reliance on debt financing that may be more prone to a "run on the bank" highlights the significance of this component of Dodd-Frank's list of factors to be considered for purpose of a SIFI designation. However, once designated, an insurance service institution will be subject to bank-like capital re-

quirements, even though the nature of claims on its assets appears to differ considerably.

Conclusion

Viewed through a model that emphasizes run-prone liabilities to determine whether a financial institution is systemically important, designating narrow insurers as SIFIs could increase the regulatory cost of producing insurance while offering little in the way of additional stability-benefits. SIFI designations will cause insurers to delegate resources toward compliance instead of more productive endeavors. Stronger competitive pressures under the latter scenario could fundamentally increase wages and lower insurance premiums without compromising the financial system's integrity.

One could certainly argue that the insurance regulatory governance framework has been greatly enhanced over the last several years through the NAIC's "Solvency Modernization Initiative." This has included an emphasis of enhanced oversight at the group level, as well as concrete reporting and regulatory scrutiny related to holding company transactions, group-wide risk management protocols and corporate governance.

In addition, insurance regulators now have a more enhanced and well-defined holding company examination authority through NAIC model law development. Given this, together with other initiatives to promote a convergence of, and more uniformity in, international supervisory authority, one may certainly question the need for another layer of regulation engendered through a federal SIFI designation.

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