Chapter 14*

Insurance Industry

Overview

The social welfare created by insurance is unquestionable. Insurers pool and diversify idiosyncratic risks with potentially catastrophic consequences for individuals and businesses. In competitive markets, Insurers price diversifiable risks on an actuarial basis, yielding tremendous utility gains to the previously exposed individuals and businesses. The broad role of insurance in the global economy is therefore not surprising. For example, premiums collected by Life, Health, and Property Casualty insurers total $1.28 trillion or 9.0% of nominal GDP in the United States in 2008 (National Association of Insurance Commissioners).

The Financial Crisis

The insurance sector played a crucial role in creating the boom of 2004-2007 by deviating from the traditional insurance model and providing insurance against macroeconomic events and other nondiversifiable risks. Some insurers, notably the monoline insurers and AIG, did so by writing financial guarantees on structured financial products tied to subprime mortgages. † These guarantees – which insurers provided in the form of both insurance policies and significantly substitutable credit derivatives – yielded huge losses and/or liquidity requirements for the insurers when the guaranteed assets declined in value, as the housing market and overall economy deteriorated during the financial crisis. Mortgage insurers were similarly affected by the deterioration in the housing market. In addition, some large life insurers, notably AIG, Hartford Financial Services and Lincoln National, deviated from the traditional insurance model by aggressively writing investment-oriented life insurance policies with minimum guarantees and other contract features that exposed the insurers to equity and other investment markets. These insurers experienced large losses as these markets declined during the crisis.

Insurers' impaired solvency and liquidity contributed significantly to the severity of the financial crisis and the need for governmental support. Downgrades in the monoline insurers' credit ratings led to declines in the value of the guaranteed bonds and contributed to the overall dysfunction in debt markets. AIG remains under government receivership, and Hartford Financial Services and Lincoln National have received significant capital infusions from the government.

The insurance sector assumed nondiversifiable risks with inadequate capital and liquidity, and its impaired solvency and illiquidity during the financial crisis exacerbated systemic risk worldwide. It is surprising, therefore, that regulatory reform plans have not focused to any significant extent on the insurance sector beyond suggesting a few preliminary steps.

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† AIG also incurred large losses on its securities lending and repurchase agreement transactions.

Current Proposals

The bills under consideration in the House of Representatives and Senate contain four main proposals regarding the regulation of insurance. First, the House Bill proposes the establishment of the Federal Insurance Office within the Department of the Treasury with the following mandate:

> (A) To monitor the insurance industry to gain expertise. (B) To identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system. (C) To recommend to the Financial Services Oversight Council that it designate an insurer, including its affiliates, as an entity subject to stricter standards. (D) To assist the Secretary in administering the Terrorism Insurance Program established in the Department of the Treasury under the Terrorism Risk Insurance Act of 2002 (15 U.S.C. 6701 note). (E) To coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, including representing the United States as appropriate in the International Association of Insurance Supervisors or any successor organization and assisting the Secretary in negotiating covered agreements. (F) To determine whether State insurance measures are preempted by [certain] covered agreements. (G) To consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance.

This list indicates that the proposed Federal Insurance Office would investigate and represent the insurance industry but have no direct regulatory powers. Instead, it would refer any regulatory problems it identifies to other regulators. For example, it would "recommend to the Federal Reserve any insurance companies that the Office believes should be supervised as Tier 1 Financial Holding Companies." The Senate bill is substantially the same as the House bill regarding the Federal Insurance Office.

Second, both the House and Senate bills propose systemic risk regulators: the Financial Services Oversight Council in the House bill and the Agency for Financial Stability in the Senate bill. Both bills do not give adequate recognition to the potentially systemically risky nature of insurance. For example, the voting membership of the Financial Services Oversight Council would not include any member with insurance expertise. A nonvoting member would be taken from the state insurance regulators, but not from the Federal Insurance Office. The voting membership of the Agency for Financial Stability would at least have a member with "experience in insurance industry or regulation," but again not from the Federal Insurance Office.

Third, both bills propose mechanisms to bring strong federal regulatory authority over any bank or financial holding company with significant systemic risk. This would presumably include "AIG-like" insurance entities but not the other large insurance companies such as Hartford Financial Services, Metropolitan Life or Lincoln National.

Fourth, the Senate bill contains some specific proposals for reforms of state-based insurance regulation.

Evaluation of Proposals

We support the creation of the National Insurance Office. However, we recommend that the legislation go further and create a National Insurance Regulator and an optional or even mandatory federal charter for financial institutions with a significant presence in the insurance industry. The National Insurance Regulator would develop deep expertise in insurance and in the institutions it regulates. It should have equal status in the systemic risk regulator (i.e., the Financial Services Oversight Council or Agency for Financial Stability) as the regulators in the commercial banking, securities and asset management industries. The creation of a National Insurance Regulator and federal charter would be less costly and otherwise more efficient than the current state-level insurance regulation for insurers operating nationally.

There is no mention in the bills about the State Guarantee Funds, which currently impose ex post assessments on the healthy insurers operating in a state to pay the claims of the policyholders of insolvent insurers (for some lines of business only). These funds are inadequate to deal with the multiple insurer insolvencies that could result in financial crises. We recommend that these funds be replaced with a National Insurance Guarantee Fund analogous to the FDIC that imposes ex ante premiums on insurers. Such an entity would be in a better position to anticipate and manage insurer insolvencies. Currently, there is an implicit federal guarantee for the large insurance companies without any adequate funding to provide such guarantees when needed.

We support a dedicated regulator for financial institutions that impose systemic risk to the financial system. This regulator should have the mandate and expertise to cover all of the functional areas of the financial system, including insurance. We are surprised that the bills do not mention insurance companies (besides financial holding companies like AIG) as potentially systemically risky. Six of the top 30 systemically important global institutions identified by the Financial Stability Board of Bank for International Settlements are insurance companies. A primary focus of this regulator should be on understanding the interconnectedness of the activities of these institutions and anticipating how they could lead to systemic risk. This regulator should charge these institutions a fee for their systemic risk contributions.

There is hardly any discussion in the bills about specific regulation of insurance companies relating to their systemic risk. On this front, we recommend that

a. Insurance companies should not be able to offer protection against macroeconomic events and other nondiversifiable risks unless the insurance is backed by adequate capital and liquidity. Currently, insurance companies are able to take one-way undiversified bets on risks without holding adequate capital or liquidity. Such protection would cover credit-default swaps on AAA-tranches of CDOs (collateralized debt obligations), insurance against a nuclear attack, the systematic portion of insurance on municipal bonds, minimum guarantees on equity indices, and so forth.

b. Financial reporting by insurance companies should provide regulators and investors with better information about insurance policies that effectively are written put options on macroeconomic variables and other nondiversifiable risks. These disclosures should clearly indicate concentrations of risk, how historical data are used to value the positions, and other important estimation assumptions.

Some additional accounting changes are necessary for insurance companies: The accounting for insurance policies should be made more/reasonably consistent with the accounting for risk-transferring financial instruments, such as derivatives. Fair value accounting, the usual accounting approach for these other financial instruments, is the best way to do this, but a not-too-distant alternative such as fulfillment value accounting may be adequate. In particular, the income smoothing mechanisms in statutory accounting principles (SAP) should be eliminated.