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COMMENTARY

Insurers, Unlike Banks, Pose Limited Systemic Risks, Says Promontory's Toppeta

William Toppeta, senior adviser at Promontory Financial Group and a former senior executive at MetLife Inc., says insurers' involvement in systemically risky activities is much less than those of systemically important banks, which will fall under special regulatory supervision. He says insurers may shed units as a result.

Governments worldwide in the post-financial crisis era have intensified their efforts to eliminate or diminish risk to the financial system. One result is that 28 global institutions have been designated as systemically important banks (G-SIBs) and are singled out for special regulatory supervision.

Two separate and hopefully related processes are under way affecting U.S. insurers. The Financial Stability Oversight Council (FSOC), which the Dodd-Frank Act created, is employing a three-stage process to designate non-bank systemically important financial institutions (SIFIs), potentially including insurers. Internationally, the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) are engaging in a different process to designate global systemically important insurers (G-SIIs).

Whichever process is employed, the fundamental questions are these: Why would any insurer be systemically important? Could any insurer's disorderly failure significantly disrupt the wider financial system or the overall economy? These questions demand clear, crisp answers.

Whether and how the two processes are being harmonized is unclear. Both have shortcomings, but the FSB seems to have the better of the two methods, because it explicitly accounts for the true nature of the insurance business.

Indeed, the IAIS has concluded that insurers as insurers are not systemically important. The IAIS has said: "In summary, neither long experience of insurance markets nor information arising from the global financial crisis provides any evidence of traditional insurance either generating or amplifying systemic risk within the financial system or in the real economy. The potential for systemic importance is only considered to arise in any non-traditional or non-insurance activities which may be undertaken by a small number of insurers." And who would know better than the insurance supervisors themselves?

Under the FSB/IAIS methodology, therefore, the primary factor that may lead to insurer designation as systemically important will be non-traditional, non-insurance activities. The IAIS has suggested that non-insurance activities might include credit-default swap and collateralized debt obligation underwriting; capital market business; banking; and third-party asset management. Non-traditional insurance activities may also include things like alternative risk transfer, including insurance-linked securities; financial guarantee insurance; and finite reinsurance.

The current proposal is that a company designated as a G-SII will be required to produce a systemic risk reduction plan (SRRP), a plan to reduce or eliminate the activities that might make it systemically risky in the first place. It is important to note that the SRRP has no precedent in banking regulation. Because insurers' core business is not systemically important the regulatory approach appears to be to encourage, and potentially even to require, insurers to exit any systemically important activities in which they may be engaged. This approach itself amounts to a recognition that insurers generally have very limited systemic significance.

Before the SRRP is executed, it is likely that the G-SII will encounter additional capital requirements and enhanced supervision. The required capital uplift could be 10 percent to 30 percent above the prescribed capital requirement. The supervision would involve greater liquidity planning and management as well as recovery and resolution plans (RRPs) for effective resolution, in addition to the SRRPs.

A lot of ink has been spilt on this issue, but little of it addresses the fundamental questions of why and how insurers are systemically important. That case hasn't been made.

In fact, empirical evidence that insurers are systemically important is scarce. Instead, the data indicates they are not. Recently, the highly regarded Geneva Association published a cross-industry analysis of systemic risk indicators comparing the 28 G-SIBs to 28 of the world's largest insurers.

The overall conclusion from the data is that the insurers' involvement in systemically risky activities is much less than that of the G-SIBs. The essential difference comes from the different business models of banks and insurers.

Maturity transformation is core to the business model of many banks, meaning they borrow money short to lend long. The insurance business model is primarily liability driven. Insurers generally match their assets with their liabilities to liquidate those liabilities when they come due. Insurers don't engage in much maturity transformation.

The Geneva Association research also factually demonstrates that insurers are significantly smaller than banks, that they write considerably fewer credit-default swaps than banks and that they are much less interconnected to other financial service providers than banks. These facts should be carefully considered in determining whether any insurers are systemically important.

Besides, any insurers designated as G-SIIs will probably be motivated to shed systemically significant activities and be required to file plans with their regulators to show how they would do so. Thus, the universe of systemically important insurers is likely to be small at the outset and shrink further over time. No one has a crystal ball, but that is likely the right outcome from a public policy perspective.

Regulators and supervisors, after all, have limited financial and human resources, so it makes sense that they focus those resources on risks already known to have destabilized the financial system in the past. The traditional business of insurance clearly has not been identified as one of those risks.

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