Financial Research Advisory Committee
Research Subcommittee

OFR Study on the Insurance Sector Recommendation

Recommendation: The Office of Financial Research (OFR) should conduct a detailed study to determine whether and where systemic risk issues may arise in the insurance industry and how such risks are currently handled in the regulatory framework. The study should engage all the major stakeholders of the insurance ecosystem, include a review of the existing literature on systemic risk and the insurance industry, and clarify areas of the insurance industry that are less likely to pose threats to financial stability, thereby providing useful guidance on the scope and priorities of any potential reforms being considered by the Financial Stability Oversight Council (FSOC).

Background:

Insurance is a large and multi-faceted industry incorporating a wide range of products and activities. In order to facilitate risk management and financial planning, the largest insurance firms offer their clients an array of financial services and products, some of which mirror products offered by banks and other financial institutions that are currently being evaluated for potential systemic risk.

Furthermore, the industry is amongst the largest holders of financial securities and biggest participants in the exchange-traded and over-the-counter (OTC) derivative securities markets. Two of the larger players in the industry have already been designated by the FSOC as being systemically important financial institutions (SIFIs), but a comprehensive review of industry practices and organizations to assess risks to financial stability has not been undertaken.

However, the insurance industry differs in several important ways from traditional financial institutions, therefore the usual approaches to analyzing systemic risk among banks and broker/dealers do not necessarily apply to insurance companies. For example, although insurance companies hold significant amounts of illiquid securities, they do not make use of leverage and liquidity transformation in the same way that depository institutions do, hence they may be less prone to “runs”. Similar to bank syndication of securities, insurers syndicate their risks to reinsurers, but unlike a bank syndication, any failure of the reinsurer brings the risk back on to the balance sheet of the insurer. Since a single reinsurer covers multiple insurers, the failure of a reinsurer could have systemic implications. Reinsurers, in turn, engaging in the practice of retrocession—shifting part of their risk to other reinsurers—can lead to run-like “spirals” when a reinsurer inadvertently and unknowingly takes back some of the risks it offloaded.

Because of such differences between the insurance and financial industry, the OFR should engage in open dialogue with all the stakeholders of the insurance industry before finalizing its research agenda in this area. These stakeholders include representatives from insurance academics, actuaries, brokers, underwriters (both property/casualty and life), reinsurers, state regulators (via the National Association of Insurance Commissioners, or NAIC), Financial Accounting Standards Board/ International Accounting Standards Board (FASB/IASB), and the Federal Insurance Office (FIO). A number of studies on systemic risk and the insurance industry have already been published by these stakeholders (e.g., Cummins and Weiss, 2013; Harrington, 2009; IAA, 2013; IAIS, 2012; Weisbart and Hartwig, 2011; Weiss, 2010), hence a comprehensive literature view may be a useful starting point.

From our subcommittee's perspective, there are several aspects of the insurance industry that are particularly relevant for financial stability:

- Insurance firms, like other large financial institutions, are opaque with respect to asset and liability compositions and, unlike banks, they are not obligated to provide detailed data about their holdings and risk exposures to any central repository or regulator.
- Size in the insurance industry affords the same benefits of diversification, economies of scale, and market power as in the banking industry, hence insurance firms have the same economic incentives to become too big to fail, yet there is no insurance equivalent of the Federal Deposit Insurance Corporation (FDIC) or the Federal Reserve Bank discount window (except in the case of the two insurance SIFIs) to provide liquidity backstops.
- Several of the largest players in the insurance field are mutual and so do not face the same market-based discipline of other large financial institutions.
- Insurance is highly regulated, but this regulation is fragmented, not focused on systemic risk, and, until the Dodd-Frank Act, was entirely at the state level.
- Many of the relevant accounting, capital-requirement, and other regulatory rules reflect the longer-term orientation of insurance activities and therefore do not allow easy comparisons with more traditional banking institutions.
- The cyclicality of the insurance industry's profits between "hard" and "soft" markets implies specific periods during which underpricing of risk becomes an industry-wide phenomenon, implying the potential for coordinated failures among multiple insurance and reinsurance companies.

As recent history has illustrated, the industry is complicated since it combines many different types of insurance activities with other ancillary activities that go hand in hand with parts of the insurance business, e.g., investment management, proprietary trading, derivatives trading, and stock lending. The largest insurance companies have also become broader over time, offering an array of financial services to their policy holders. There are also some reports that regulatory arbitrage is driving the organization of parts of the industry and that leverage and illiquidity, measured broadly, seem to be rising.

A historical review of insurance industry practices and experiences might also contain useful information for the OFR. There are cases of insurance firms in some countries being found to be capital deficient and being forced to raise substantial amounts of equity in short notice. Case studies of how this adjustment process worked could be of independent value. Insurance companies and their regulators undertake their own stress tests, and exchanging ideas with these parties could be mutually beneficial.

Finally, our call for a study does not pre-suppose an answer to whether this sector poses any threats to financial stability. Rather, we believe it is necessary to understand more fully the role that such non-deposit-based institutions play in financial markets and to identify any potential impact on financial stability that this industry may have well before a systemic shock occurs.

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