What's an Insurer to Do:
Industry and Regulatory Impact of Current Market Developments

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It is a pleasure to appear before you this afternoon to outline the issues current financial markets pose for life, health and other insurers and their regulators. Thank you not only for inviting me, but also for asking that I speak briefly to leave lots of time for discussion – without this constraint, current market conditions could lead to a talk that takes up the rest of the afternoon. But, as has been famously said, the prospect of hanging concentrates the mind wonderfully, so I'll be brief.

In the wake of mind-bending market events – and I hope we're in the wake, not the trough – we will see new safety nets and rules for investment banks and systemic-risk institutions – GSEs included – and a new statutory framework. This could be only the type of a rewrite we saw in the early 1990s after the S&L debacle. But, I think it will go further and be a global overhaul of U.S. financial services in a manner akin to that of the 1930s.

So, what will happen to insurance firms in the midst of this maelstrom? What should regulators and those who stand behind them – all of you here today from the state guarantee agencies – do? There's no set of easy answers – and, of course, the maelstrom is still raging, but let me outline a couple of take-away conclusions I think are already clear and then go into a bit of detail on them.

- As recent events have made painfully clear, no one is safe now. If Treasury and the Fed can't jawbone market confidence for Fannie Mae and Freddie Mac, all financial-services firms – insurers included – are subject to liquidity risk and potential equity drains. This warrants immediate, forward-looking contingency planning with a sharp focus on reputational risk at all financial institutions, insurers included.

- The ongoing panic puts a lot of pressure on state regulation. Insurance firms that trip the wire differentiating systemically-significant firms from the rest of the pack will face direct and indirect federal regulation going forward. This may come through Treasury, the Fed or some other entity but it is coming. Solvency II will also force a conglomerate regulator for U.S. insurers comparable to the consolidated supervised entity created by the SEC, but a new focus on prudential regulation will make this a tougher framework than the industry now anticipates.

- On the bright side, "back to basics" banking means a return to more traditional financial products and, thus, a resurgence of a wide range of insurance products in contrast to more complex and structured forms of risk transfer.

Taken on Faith Takes a Hike

I'm not sure for how long financial markets were lulled into the complacency that led them – not to mention their regulators – to miss an array of glaring warnings. But, I know it's been long enough to mean that bad habits are deeply embedded in an array of institutions and the rules that govern them. This is one of the reasons the markets now are taking nothing on faith – investors were so rudely awakened to risks at once-indomitable firms that they no longer believe anything anyone tells them about the financial sector.

So far, insurance firms have been insulated from the ravages wracking commercial and investment banks, although several that had significant mortgage stakes are sharing the fun. No insurance firm has yet been punished as brutally as other financial firms, but that is not to say that it couldn't happen. Although not dependent on retail funds like IndyMac, insurers are of course reliant on market liquidity for ongoing operations, including claims payments. Large firms are also major counterparties in an array of over-the-counter markets – most notably credit derivatives. To date, insurance regulation has focused more on solvency than liquidity – long-term ability to honor commitments, not short-term resources with which to withstand a crisis of confidence. As a result, insurers are vulnerable to the liquidity risk that has rocked firms like Bear Stearns despite capital and other resources sufficient to ensure long-term solvency.

So, what to do? First, no life, health or other insurance firm – or its regulator and guarantor – should assume it's rock-solid despite financial realities that would support so comforting a conclusion. When the market has thrown reality to the winds – as is clearly the case in the GSE and bank sector – no firm is safe and all must ensure their contingency plans anticipate fat-tail, high-risk scenarios. I think this needs to be done not only in the real world of markets – through, for example, enhanced contingency funding plans – but also in the policy ether. This means addressing in advance potential fears that could arise from policy-makers – a quick look at the damage done to IndyMac by a letter from Sen. Schumer shows how serious a risk politicians can pose in the market's current dark mood. It also means careful, advance crisis-management planning with state and federal regulators, as well as with key opinion-leaders in the financial and general media.

A simple cost-benefit analysis shows the importance of this contingency planning. Without it, an insurer can find itself under a very big gun with no warning. With it, the firm's defenses are already in place and damage – if any – should be collateral, positioning the insurer to survive in the new financial-services industry being created around us in the wreckage we already survey.

State Regulators on the Spot

All of these developments pose significant challenges to state insurance regulation and the guarantee system. While life and health firms are so far faring well for the most part, problems at several large diversified insurers and the critical problems at monoline bond insurers have raised serious questions about the sector.

As a result, we think Congress will turn in earnest to the optional federal insurance charter next year, moving it farther than one might have once thought possible because the larger question of U.S. financial regulation has changed from talk to action. It is most unlikely that Congress will create a new systemic-risk financial regulatory framework – as I think it will next year – and ignore insurance firms. Some clearly pose systemic risk by virtue of their size and others – again, think monoline bond insurers – actually raised this prospect and proved the point to many federal and international policy-makers.

However, the fact that the federal charter will advance doesn't mean it will look the same. As I mentioned, it's likely to have a far more formidable prudential focus than in the past, where the federal approach was largely focused on product development and new offerings. This is particularly true with regard to capital requirements – a major focus of federal regulatory attention these days. Solvency II could become a *de facto* U.S. insurance requirement regardless of the stand state regulators take on the rule, effectively preempting state requirements not only for internationally-focused firms, but also for any other insurer with systemic-risk impact. This will take the optional out of the federal charter for any such firm, essentially mirroring the dual banking system in which virtually every bank of size has a national charter.

To be sure, any federal system that simply supplants state guarantors will be a complex feat, if only because the contingent cost to taxpayers needs to be recognized under rules governing what's called the federal "credit budget." If the federal charter permits reliance on state guarantors – a big if – my guess is that strict rules will cover the state system to ensure it's sufficiently robust to handle the crises now all too real.

Good News?

Whew! However, there is a bright spot in all this for insurers – one we see for other well-capitalized providers of more traditional financial services. For the foreseeable future, the current crisis will wash a lot of speculative products out of the retail and institutional financial markets.

Consumers who thought their home equity and high-flying investments secured their retirement – not to mention their heirs – will think again as losses mount. This will bring investors back to life policies and annuities, perhaps opening new markets to them in the defined -contribution arena as fiduciaries there come under a lot more pressure to protect investors. Institutional investors too are returning to fundamental forms of risk mitigation, recognizing that many structures were complex fantasies built atop scant capital.

Bank and securities regulators are already forcing this return to reality. New bank capital rules require robust forms of risk mitigation and banks now don't have the excess capital with which to avoid these requirements. The SEC is pushing a tough new approach to the credit ratings agencies that too will force a return to reality – with investments judged not by a rating agency's whim, but rather on robust forms of collateral and insurance. Fiduciaries – and not just those offering 401(k) plans – are also facing a lot of tough new requirements that will force them to focus on fundamentals. And, when they do, traditional insurers will be there – there under a new regulatory framework, I would guess, but there nonetheless.

Where This Leaves Us

"Paradigm shift" is an all-too-over-used term that has taken on new meaning since an historian of science coined it decades ago. What it is meant to denote is a ground-breaking shift in how reality is understood, with that shift leading to a flood of new activity that reaches into all corners of scientific inquiry. On those terms, that's what we've got in financial services – a ground-breaking re-understanding of risk that will lead to far-reaching industry and regulatory changes. Insurance is, of course glued to the financial sector and thus integral to the new market and policy realities already rewriting the rulebook. We aren't where we were a year ago and, I think, a year from now we will see a new landscape of improved insurance regulation, a tough federal charter and far greater consumer and institutional reliance on insurance products.