Saving Private Guarantees:

The Prospects for Insurance Guarantors in the Revised Resolution Regime

Remarks by

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It's a pleasure to join this distinguished group of insurance regulators, executives and guarantee-agency heads today. I suspect we're all still in shell-shock given the year that's passed since I last met with you. In July of 2008, we had yet to realize the scope of the crisis about to unfold in global financial markets, let alone the havoc it would wreak with the economy as a whole. We did, though, foresee the threatening shadow of systemic risk not just in the banking sector, but also at AIG. This led to a lively discussion of how the bank approach to resolving troubled firms would apply in the insurance sector.

Now, of course, we're all past talk to action. The Obama Administration has proposed a refined version of Treasury's March systemic-risk resolution framework that will sweep insurers along with other non-banks into a new rescue regime. Since then, the plan has evolved, with Treasury talking up changes Congress could make to refocus the resolution process more on orderly closure than ready rescue. I've called the initial Treasury plan "TARP on steroids" because it would have allowed federal tax dollars to support any big firm any time for any reason, and I'm very glad to see that the new approach rolls much of this back.

Even so, though, the plan still has profound impact for life and other insurance firms, as well as for the state-guarantee system on which insurers have relied for decades. This is particularly true for systemic-risk institutions which, like AIG, could be involved in activities in or outside insurance regulation that are so large and/or inter-connected with the rest of the financial system as to pose real risk. AIG wasn't per se an insurance-regulatory failure, but a failed insurer with systemic consequences only rescued with $180 billion or so of federal money. Could the state structure have supported AIG policyholders? I'm glad we didn't need to find out, but I think we need to be ready should there ever be a repeat of this systemic-risk close call.

But, we need I think not only to consider systemic-risk resolutions, but also the larger question of how to handle a complex insurer with deep reach into retail financial services. What would have happened to the industry as a whole if AIG's failure had threatened policyholders, let alone left some in the lurch? The FDIC exists not only to handle failed banks, but also to put a seal on a bank's door to prevent panic runs. We don't have a clear, immediate intervention capacity in the insurance sector, especially for firms that have yet to be formally closed by a state regulator. Nor do policyholders have any clear understanding of what is or isn't covered by the guarantee associations. Hearing that retirement savings could be threatened – even if this isn't true – would I think undermine other insurers. As you know all too well, several very large life insurers were hard pressed in the market crisis late last year and early in 2009. Policyholders can't run for the exit like depositors, but they can try. Significant market disruptions would also result from any doubts about a health insurer's ability to meet claims.

Worse still, if the market is shocked by unpaid claims above the guarantee levels, a massive strategic challenge to life insurers would result. The FDIC is deeply concerned that market panic will again grip the nation if it has to use its Treasury line of credit to support the Deposit Insurance Fund – that's how fragile depositor confidence remains despite all of the FDIC's actions to date that have protected all insured depositors all of the time. That's despite the fact that depositors know they're insured and understand –more or less, anyway – how the FDIC works. I think the shock of an insurance failure to retail policyholders would be profound. It could take years before customers again trusted insurers – quite literally – with their life.

So, what to do? The state guarantee system is strong but so was the FDIC before the world turned upside-down. What I'd like to do this morning is assess the critical resolution issues facing the FDIC and bank regulators to raise issues for state insurance regulators and guarantee associations. Congress is of course working on the systemic-risk part of this problem and, at the same time, international insurance regulators are constructing a new regulatory and resolution framework. Thus, these issues are upon us. A good solution to insurance intervention and, if necessary, resolution is critical not just from a systemic-risk perspective, but also for the long-term stability of the insurance industry.

Why Banks Fail

First, though, I'd like to talk briefly about why the FDIC is facing so many challenges that could come quickly upon state guarantors. Insured depositories are of course a lot different than insurance firms, but many of the underlying causes of the banking crisis have proved serious challenges also to insurers. To be sure, none other than AIG has failed. But we came awfully close all too often to bask confidently in the stability of the insurance-regulatory model going forward. Look, for example, at the monoline bond insurers for another example of a very, very close call both with company failure and systemic risk.

State guarantee agencies can't do their job if state insurance regulators don't anticipate prudential challenges that cause solvency and liquidity crises. What are some of the common elements in bank prudential regulation that also challenge insurers?

First, there's the way regulatory capital is structured. Here, I think some insurers have a lot to teach bankers. Look, for example, at how the private mortgage insurance (MI) industry is handling the crisis. I know the MIs aren't happy, but they are meeting all of their valid claims. These firms are the only private entities with concentrated mortgage risk also able to take on new business. This is because the MIs have a unique form of counter-cyclical capital – they put away half of every premium dollar for ten years to ensure catastrophic-risk claims-paying capability. Bank regulators are now working hard to rewrite their risk-based capital rules, and I hope they will look hard at the MI model and other insurance approaches to end the boom-bust banking cycle.

But, that bank capital could learn from insurance isn't to say that insurance regulatory capital is bullet proof. We've learned the hard way that this isn't true. One reason, of course, is that – like banks – insurers have long relied on the credit ratings agencies (CRAs). CRAs goofed more than a bit of late, both on the undue optimism – I like to think it was just that – that bestowed AAA ratings with abandon and, now, on the downside – when ratings downgrades come without warning and often also without real reason.

Ratings reliance means that, despite counter-cyclical capital structures, insurers are still at risk from macroeconomic events, sectoral downturns or just a change of heart at the CRAs. The new approach to managing independent credit risk analytics is of course aimed at fixing this, but unless or until it does, insurers are subject to sudden risk not well anticipated in their current regulatory regime.

Another bank issue with insurance impact: lack of stress testing. With the important exception of contingency reserves, insurance capital is judged on a moment in time, not a tough scenario analysis that includes fat-tail – that is, catastrophic – risk. This means that capital can run dry right at the time that private capital infusions are, at best, hard to find.

Inter-affiliate risk is now a major focus of bank regulators, but it's one with clear insurance impact as well. Sections 23A and 23B of the Federal Reserve Act are designed to insulate an insured depository from higher risks and conflicts of interest in the parent holding company. These rules haven't done what they were supposed to in the recent crisis, and the Obama plan would tighten them up. However, as AIG and the monoline bond insurers made clear, inter-affiliate risk is also a significant insurance issue – look, for example, at the degree to which insurance capital was based on obligations insured by an affiliate.

And, one more bank issue with insurance implications: liquidity risk. In part because of undue CRA reliance, financial institutions had a very tough time facing claims by counterparties or renewing short-term funding that backed long-term obligations. Absent market panic, insurers happily aren't subject to the overnight liquidity risks banks face when depositors balk, but Bear Stearns wasn't a bank and it bit the dust. Liquidity risk is rampant throughout the financial-services industry, and insurers are no exception.

Reckoning with Real Risk

Based on this quick review, it's clear that insurers face prudential risk yet unrecognized in the regulatory regime. This means that we could experience serious challenges even as we recraft both the regulatory and resolution regimes that proved so fragile in this crisis. Looking beyond the common regulatory elements that pose a challenge to insurers, what have we learned from failures to handle bank resolutions?

First, non-bank affiliates threaten banks. This was of course also true for AIG, where regulated insurers were brought down by non-insurance risk, as well as by the complexity of an opaque insurance firm with overlapping regulation and cross-cutting claims between U.S. and offshore entities without the inter-affiliate barriers I mentioned a moment ago and non-transparent corporate structures. Resolutions through typical guarantee-agency strategies could be complicated, if not impossible.

Second, QFCs quash claims. By this, I mean that derivatives, securities agreements and other complex arrangements called qualified financial contracts threaten the ability of receivers like the FDIC to get what they think is due in a liquidation. Banking and bankruptcy laws mean that QFC counterparties clear out the till before other claimants line up, and their priority lien trumps even that of federal and state regulators. The Administration's legislation addresses this for systemic-risk resolutions, but it's worth careful consideration more broadly with regard to the future of insurance resolutions through the guarantee agencies. To date, most failed firms have been small and their QFC exposure very limited, but that won't be the case going forward.

Another hard lesson: counterparties act first and think later. Panic runs are, as I've mentioned, less likely in life and health insurance, but they're far from impossible. Depending on the policy, holders have cancellation rights as well as certain cash claims. Any short-term use of these rights would create significant liquidity, if not also solvency risk for insurers just as it does for banks when depositors and other counterparties head for the exit. At the parent level, many large insurers also funded long-term obligations with short-term instruments in the run-up to the crisis, exacerbating strain on them and even threatening the viability of several major firms. Think of all the companies that sought desperately to become financial holding companies to get access to an FDIC debt-guarantee program.

Finally, resolutions may cost a lot more than we reckon with. This is a sad lesson for the FDIC, which is finding its recovery rates far lower than in prior banking crises like the S&L debacle. State guarantee agencies may have more time to handle claims than the FDIC and thus better odds of realizing larger returns on seized assets, but that's far from certain. Under stressed conditions, regulators also face credit and market risk, and this isn't just the case for the banking industry. We've come a long way from the days when a regulated firm's assets were long-term, transparent ones with clear collateral value and this will require a revised strategy for insurers as it already has for banks.

Readying the State Resolution Regime

So far, I've been nothing but glum. I've focused almost exclusively on risks insurers have yet to reduce and resolution threats still unaddressed. The state insurance-resolution system has done an awesome job to date, but that's in part because the federal government has stepped in. This is true not just for AIG, but also TARP – provided to some insurers, as you know, and other programs that support firm holdings and funding requirements. These supports have revealed potential gaps in state guarantors, gaps largely a result of an historic focus on orderly resolution of small, limited firms during periods of economic calm. Like the SIPC, the insurance–resolution regime is largely focused on fraud, not prudential risk, but we now know all too well how quickly these pressures can bring a firm to the brink.

To make the state guarantee system work better means making state insurance regulation work better. You won't get to do your job if an affiliate risk quickly takes down a firm you back. Bank regulators are looking at new firewalls between insured depositories backed by the FDIC and non-banking affiliates that should be left to the not-so-tender mercy of the market. If these inter-affiliate and parent company issues aren't addressed, guarantors may have no choice but to stand aside and let the federal government rescue an insurance firm as a whole.

Similarly, a lot of advanced thought needs to be given as to how to intervene in an insurance company – and its affiliates – when trouble looms. Without what bank regulators call prompt corrective action, manageable problems metastasize and orderly resolutions can become all but impossible. This is particularly true for you because your funding is ex post, not up front, meaning you have no resources with which to handle all but a failed institution.

A review of how much you'll get in a receivership is also in order. Bank regulators aren't the only ones at risk for qualified financial contracts and banks aren't the only financial institutions that have them. State regulators and guarantors have little control over QFC treatment because it's embodied in federal bankruptcy law, with Congress now only considering reform with regard to systemic-risk institutions taken over by the federal resolution agency. You may want to get your perspective on this issue in play quickly to ensure state resolutions are also protected.

Where Next?

To date, the state guarantee structure has worked awesomely well, but I think that's in part because the federal government stepped in at AIG and could have done so at other major firms. Insurers facing stress also found ways to cozy up to the federal government, at the least using hoped- for access to TARP funds and other facilities to fend off short-term crises. When I think about insurance regulation – from both a systemic-risk and day-to-day perspective – I see an array of prudential standards that have yet to be instituted in state insurance regulation because the overall model largely predates the structure the industry assumed in recent years. This is, I think, the reason the Treasury is now proposing largely to swoop in and preempt state regulation and resolution for systemic firms, but it also points to a longer-term challenge to the entire industry going forward.

Without a clear, up-front and incremental approach to handling complex insurance firms, state regulation and resolution will lag behind market reality. We're in the eye of the storm right now, with firms feeling humbled and markets being extra-cautious. That won't last, though, and we'll soon be back to more freewheeling ways absent work now to reflect hard lessons of the last few months.