Policy Drivers:
Charting the New Course for
U.S. Insurance Companies

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Conclusions

- G-SIIs, other insurers subject to the FRB face material business challenges due not only to capital rules, but also liquidity, stress-test, and resolution standards. Lack of insurance prudential/resolution protocols for complex activities mean *de facto* imposition of bank-centric rules with significant policy-driver risk to consolidated P&L.

- However, on a line-of-business basis, insurance standards can be more favorable for credit-risk taking, creating policy-driver opportunity.

- Asset management in insurance entities also enjoys policy-driver opportunity.

- Insurance is segmenting into sectors based on size and charter complexity. Current U.S. state-based insurance regulation/resolution works well for the traditional sector, albeit with costs resulting from barriers to entry, innovation delays, pricing controls, and hazards (potentially systemic) resulting from regulatory competition to attract regulated entities. New ventures are constrained also by the unwillingness of federal regulators to trust insurance coverage, especially under stress scenarios.

- Policy-driver risk exists for activities (e.g., cyber insurance, MI, infrastructure) dependent in part on federal authorization or recognition.

This policy brief does not address the question of whether systemic designation and related regulation is the correct policy for U.S. insurance companies, nor does it discuss the types of rules that should or should not apply to U.S. insurance companies regardless of size or charter. Instead, it assesses current and prospective policy drivers – legislative, regulatory, and public-policy forces – to demonstrate their competitive impact and the emerging reconfiguration of financial services in the U.S., as well as resulting competitiveness and corporate-governance challenges. Winners and losers on both a line-of-business and franchise basis are defined based on Federal Financial Analytics' proprietary advisory practice. Issues are presented as in the brief requested by NFI, key issues and conclusions are noted in outline format.

1) <u>Insurance Can be Complex, Highly Inter-Connected, Cross-Border</u>

- Traditional insurance operations now take place in tandem with highly-complex capital-markets activities (e.g., OTC-derivatives clearing, securities financing, asset management, lending). State-based insurance regulation generally does not capture these activities and often has no prudential jurisdiction over it.
- Insurance demonstrated its systemic reach not only due to AIG, but also to near-misses in 2008 due to weakness in large bond insurers (resulting from correlated risk, non-traditional investment and MI, resulting from poor underwriting, correlated risk, governance problems). Many more traditional insurers were also at great risk during the crisis due to liquidity freezes and other market stress, with survival dependent on overall FRB and FDIC liquidity interventions in the U.S. and in the global financial system. Now, 13(3) and other post-crisis constraints limit or even bar similar support in future crises.
- FICC-market illiquidity, HFT risk, other post-crisis market-structural factors pose significant challenges to all insurance business models.
- Current interest rates, changing demographics also pose structural risk.
- Emerging insurance activities (e.g., cyber coverage) pose new systemic challenges due to concentrated exposures, modelling challenges.
- Some insurance (e.g., MI, bond) is credit enhancement, not traditional actuarial risk transfer. These activities may also not be readily substituted by other providers if current entities fail or cease writing new business under stress.
- The bank regulatory framework creates significant opportunities for insurance companies, especially those outside the SIFI/FRB -framework.

2) <u>The FRB is Demanding Rules to Internalize Negative Externalities, That Redefine Large Companies</u>

- Outside of guaranty associations, there is no U.S. framework for insurance resolution, especially for insurance companies affiliated with G-SIBs and G-SIFIs. The FDIC's preferred resolution protocol – "single point of entry" – is not ready for insurance, including banks with significant insurance activities/parents. Conflicting home-host protocols (e.g., for insurance subsidiaries of G-SIFIs) pose particular risk.
- Bankruptcy resolution for insurance parents and subsidiary companies is complicated by lack of automatic stays except under OLA. Counterparties will prefer insurance, asset-management exposures due to Bankruptcy Code protection vs. ISDA contractual limits now adopted by large U.S. banks.

- The global framework protects financial stability at the expense of policy-holders, creating significant discontinuity with U.S. standards (where applicable).
- New TLAC standards for G-SIIs pose complex challenges in the absence of resolution frameworks, bank-like capital.

3) <u>Claims-Paying vs. Prudential Regulation: Old Rules Not Ready for New Risks</u>

- Current U.S. insurance resolution protocols generally presume only short-term liquidity risk, not parent-company or insurance-subsidiary insolvency. Contagion scenarios are also not well accounted for (e.g., no funder of last resort).
- State agencies lack prompt corrective action authority buttressed by clear non-viability criteria to reduce resolution cost, contagion risk.
- "Living will" standards have not been constructed for complex insurance companies, including SIFIs, nor have stress tests been conducted except in limited fashion for some SIFIs. These stress exercises are highly problematic and pose strategic challenges when structured in bank-centric fashion, but do support recovery and resolution. Qualitative capital-planning criteria also support resilience, incentive alignment.
- Risk correlations within diversified insurance companies and intra-group risk transfers challenge claims-paying capacity. Sovereign-risk concentrations are a significant concern, as is liquidity risk resulting from bond holdings used as a capital buffer. Ratings reliance also creates event risk, additional correlations across the portfolio and capital base.

4) <u>Losers Due to New Policy Drivers</u>

- SIFIs and FRB-regulated companies due to distortions resulting from bank-centric rules, compliance/implementation cost, diversion from business priorities.
- Insurance activities dependent on federal recognition via charter advantages, recognition in bank-capital rules, use to offset policy risk.
- State insurance regulators that lose *de facto* authority over major firms, policy credibility.
- Banks and insurance companies dependent on intra-group synergies not reflected in applicable regulatory models.
- Cross-border firms subject to conflicting standards.

5) <u>Winners</u>

- Insurance companies that anticipate the new prudential framework and work with policy-makers to craft a robust set of standards (not just capital rules) suitable for insurance companies that reflect new risks, desired product and service offerings.
- Insurance companies without bank operations or SIFI designation offering asset-management, capital-markets, and retail financial products.
- Companies that conduct line-of-business policy-driver analytics in advance of new rules, activist-investor demands.