AMERICANS
FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
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January 25, 2016
International Association of Insurance Supervisors
c/o Bank for International Settlements
Basel, Switzerland

Re: Public Consultation, Non-Traditional, Non-Insurance Activities and Products

To Whom It May Concern:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced Public Consultation on Non-Traditional Non-Insurance Activities and Products (the 'Consultation') by the International Association of Insurance Supervisors (the "IAIS"). AFR is an American civil society organization coalition of more than 200 U.S. national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

AFR was created as a response to the financial crisis of 2008. Insurance companies played a significant role in this crisis, both directly and indirectly. American International Group (AIG), the world's largest insurance group at the time, was at the epicenter of the crisis, and of course collapsed and required the largest government bailout in U.S. history. Monoline financial guaranty (bond) insurance companies and mortgage insurance companies also played a major role in the crisis and in some cases also collapsed.[2] While these links between the financial crisis and the insurance industry were well publicized, it is less well known that life insurance companies offering large amounts of variable annuities also took heavy losses and came under enormous financial pressure due to market-linked liabilities and the failure of their hedging strategies in stressed markets.[3] In some cases these pressures, and their intersection with regulatory capital requirements, led to fire sales that increased losses in distressed markets.[4]

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[1] A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Schich, Sebastian, "Insurance Companies and the Financial Crisis", OECD Journal, Financial Market Trends, Volume 2009, Issue 2, Organization for European Cooperation and Development, October, 2009. Available at http://www.oecd.org/finance/financial-markets/44260382.pdf
[3] McKinsey Consulting, "Responding to the Variable Annuity Crisis", McKinsey Working Papers on Risk, April, 2009; Du David Fengchen and Cynthia Martin, "Variable Annuities – Recent Trends and the Use of Captives", Federal Reserve Bank of Boston, October 7, 2014.
[4] Acharya, Vidal and Matthew Richardson, "Is The Insurance Industry Systemically Risky?", Conference Paper for Brookings Institution Conference On Insurance Regulation, October 14, 2014, available at

The overall issues around insurance regulation are of course complex. As holders of long-dated liabilities that are in some cases naturally diversified, insurance companies can potentially play an important financial stability role as a natural purchaser of assets in illiquid markets. Whether these benefits are realized depends on the details of insurance regulation, especially capital and reserving rules. But the nature of insurance company liabilities is also a critical factor, and can result in insurance activities that create financial stability risks, not benefits. The financial crisis experience demonstrates that insurance companies that take on non-diversifiable systemic risk linked to the performance of the financial sector or of key financial assets can create significant risks to the financial system. When insurers provide financial guaranty products, they can both fuel the growth of asset price bubbles and also be among the most exposed to asset price declines when such bubbles deflate.

We believe that improvements in insurance company regulation are necessary to address such systemic risks. While the traditional U.S. system of state based insurance regulation has many strengths, the end of traditional legal (Glass-Steagall) separations between insurance and other forms of financial activity in the U.S. has contributed to an increase in the size of insurance companies and the complexity of insurance activity. The end of Glass-Steagall, the provision of financial guaranty products directly linked to asset prices, and the increasingly globalized nature of insurance raise broad systemic issues that local regulators may not always be fully equipped to address.

In this light, we welcome the IAIS initiative to highlight Non-Traditional, Non-Insurance (NTNI) activities and to coordinate global efforts to provide better oversight of such activities. We believe the conceptual framework laid out in this Consultation (as well as previous IAIS documents such as *Insurance and Financial Stability* and the *G-SII Policy Measures)* is a helpful one and likely to highlight insurance company activities most linked to systemic risk. Among the strengths of this framework are:

1) A clear focus on the dangers of non-diversifiable market risks created by financial guarantees. These risks are not reduced by the law of large numbers in the way that naturally diversified non-market risks (e.g. property and casualty losses) are.

2) The application of the framework to both institutional financial guarantee products, and to individual consumer products such as life insurance annuities directly linked to market or asset price indices.

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http://www.brookings.edu/~/media/events/2014/10/14-insurance-regulation/acharya_richardson_paper.pdf; Merrill, Craig B. and Nadauld, Taylor and Stulz, René M. and Sherlund, Shane M., Were There Fire Sales in the RMBS Market? (May 6, 2014). Charles A. Dice Center Working Paper No. 2014-09; Fisher College of Business Working Paper No. 2014-03-09. Available at SSRN: http://ssrn.com/abstract=2436887

3) Highlighting liquidity features of insurance products (such as generous surrender policies) that may expose insurance companies to run risk.

4) The recognition that hedging strategies that depend on derivatives (as opposed to clear ownership of underlying assets) may fail in stressed markets.

The dependence of regulatory action on potential hedging strategies is still an area of potential weakness in the framework. We would caution that activities which involve taking on large amounts of non-diversifiable financial risk should not be excluded from NTNI oversight simply because of claims regarding hedging of these risks. The actual time structure and nature of liabilities, the nature and liquidity of the assets matched to those liabilities, and the reliability of matched asset liquidity assumptions in stressed market conditions must all be carefully investigated. It is in this light that we strongly support the IAIS exclusion of derivatives-based hedges. Many such hedges were shown to be inadequate when life insurance variable annuities came under pressure in 2008-2009.

We do not have specific responses to most of the specific questions in the Consultation at this time. However, we would like to respond to Question 1, regarding the appropriateness of the term 'Non-Traditional, Non-Insurance' for systemically risky activities. We do not believe this term is appropriate. The identification of systemically risky activities should not depend on whether an activity is 'traditional' in a jurisdiction or is new. Monoline bond insurers were arguably 'traditional' in the United States prior to the financial crisis but turned out to be quite systemically risky. Although the question does not inquire as to the appropriateness of the 'non-insurance' label, we also do not believe this term should be used. Financial guaranty products, including covered credit default swaps, may be seen as insurance products and in some cases have been in the United States. Yet they are still systemically risky.

We would prefer that the IAIS use a term for these types of products that refers directly to the reasons why they pose systemic risks. These risks are generally related to financial guaranty risk and/or liquidity risk. In general, analysis of activities should not depend on static 'classifications' into traditional or non-traditional activities, but on a regularly updated analysis of the actual underlying activities and the risks it poses.

Thank you for the opportunity to comment on this Consultation. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform