AIA's Response to FSB's Recovery & Resolution Planning for Systemically Important Insurers

The American Insurance Association (AIA) appreciates the opportunity to submit comments to the October 16, 2014 Financial Stability Board (FSB) Consultation Document "Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Critical Shared Services," (the Document). AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to consumers and businesses in the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums. AIA's membership includes U.S. insurers that write insurance only within the U.S., U.S. insurers that write insurance inside and outside the U.S., and insurers that are U.S. subsidiaries of multinational insurers. This membership diversity enables AIA to analyze issues from many perspectives and enables us to draw on the global experience and expertise of our companies with many forms of insurance regulation.

The issues raised in the guidance Document are important to AIA and its members. In particular, it is important that the policy measures that will apply to insurers designated as global systemically important insurers (G-SIIs), as well as the manner in which those measures are implemented, are clear to all insurers. Further, guidance on recovery and resolution plans and the identification of critical functions and shared services must be appropriate to insurers and consistent with the insurance business model. In the Document, the FSB seeks comment on its identification of a G-SII's critical functions and shared services as part of a G-SII's resolution planning requirements. AIA's responses to the Document's consultation questions follow.

In the Document, the FSB seeks to apply its "Key Attributes of Effective Resolution Regimes for Financial Institutions," (Key Attributes) to G-SIIs. The Key Attributes, first published in 2011 (and with a non-bank-specific annex released on October 15, 2014), call upon local jurisdictions to adopt ongoing recovery and resolution planning processes to reduce the risk of failure for financial institutions, and to promote resolvability as part of the overall financial supervisory process. In July 2013 the FSB identified nine insurers as G-SIIs. Recovery and resolution planning requirements are part of a suite of policy measures the FSB plans to apply to these G-SIIs (as well as any others that may eventually be designated).

The FSB's first and third questions ask whether "the definitions of 'critical functions' and 'critical shared services'" and "the methodology for identifying critical functions" are "appropriate for the insurance sector?" AIA has concerns about these definitions. The Document seems to be geared towards definitions and a methodology that assume that consumer use and market consequences will be similar to those applied to banking products. Yet, the insurance business model and the regulated insurance activities that flow from that model do not produce the same destabilizing effects of other financial products. To the contrary, the insurance business model possesses features that add stability to the financial markets, not least of which is the fact that property-casualty insurer operations are funded by upfront premiums, which therefore reduce the need for property-casualty insurers to access the credit markets. Because the risks that a property-casualty insurer assume are typically not correlated, an insurer is not prone to a customer "run" on the company's assets and consequently an insurer can better control its cash outflows. This low leverage environment of property-casualty insurers is a key element of stability. AIA respectfully suggests that the definitions and methodology outlined in the Document would be appropriate for the insurance sector -- if they reflected the insurance business model. In terms of performing a substitutability analysis in assessing the market existence or absence of a critical function, AIA agrees that such an analysis – done correctly – would be useful. As we noted in our comments to the IAIS on its G-SII Assessment Methodology, global market concentration measures by broad product line (as opposed to measurement by premium volume) would be a more appropriate way of measuring substitutability. In the U.S., the Herfindahl-Hirschman Index (HHI) of market concentration is used by the U.S. Department of Justice in assessing mergers/acquisitions from an anticompetitive perspective. The HHI takes into account the market share of each firm in an industry. The HHI has gained wide acceptance as the public and private sector standard for measuring market concentration and assessing the competitiveness of markets.

Substitutability measurements would only be relevant for activities/product lines that have the potential to destabilize financial systems. So, for example, the Document identifies aviation and marine insurance as product lines where coverage is a "precondition for economic activity," yet those business lines have no inherent connection to systemically risky activity. Moreover, aviation and marine insurance are not well-defined and, in the U.S., differently defined terms could lead to confusion and ambiguity over the types of coverages effected. Even assuming the lines can be adequately defined and are highly concentrated, there is no evidence that failure of a company writing those coverages would cause a market disruption in certain economic quarters, much less a cascading effort across the financial system or widespread liquidity or credit problems that were at the center of the financial crisis. Indeed, any temporary disruption in the availability of aviation or marine coverage would be linked to war or an act of terrorism, and governments, including the U.S., have established programs precisely to address concerns associated with a temporary market disruption because of these events.

In addition, the Document sometimes slides between the concepts of substitutability and interconnectedness without distinction. In Section 3.4, "Investment and Lending in the Real Economy," for example, one heading reads "a highly interconnected lender increases criticality," while the next reads, "aspects for substitutability analysis." Keeping substitutability and interconnectedness distinct is critical for G-SII analysis, because the Assessment Methodology determined that interconnectedness poses eight times greater a systemic risk than substitutability.

As part of addressing question two, "[s]hould critical functions be identified based on whether the disruption of the activity would adversely impact the stability of the financial system or the functioning of the real economy or both?" AIA believes that, before a function is considered critical, the disruption of the activity should adversely impact both financial stability and the functioning of the real economy. In other words, a determination of function "criticality" should not end with the conclusion that the function is an everyday concern for consumers. Viewed this way, almost every insurance product would fall within the definition of critical, which would render insurer compliance an impossible task.

Further, the Document starts from a faulty premise. The Document erroneously suggests that greater standardization in insurance products would produce less systemically critical results by reducing complexity. "Complex and unique products may increase criticality by reducing the availability of substitutes." This analysis fails to consider the other possibility – that increased standardization could actually increase systemic risk by weeding out diversity. Any flaw in a product, or in pricing, or in a market would be magnified across the entire marketplace, with no mitigating alternative. Additionally, uniform products provide nothing innovative to consumers, and could lead to higher prices as companies have less incentive to compete. While tampering down complexity and innovation may have some regulatory appeal, it is probably to the detriment of financial stability and consumer protection.

The Document also fails to analyze deeply its suggestions of what types of insurance would be "critical." For example, the Document cites a lack of auto insurance as an inhibiting factor of an individual's ability to go to work or to shop. This ignores the fact that for many people public transportation, carpools, taxis, spouses driving in the same direction, or myriad other options may be able to deliver them to and from their destinations. Auto insurance has also proven over time to be a very competitive market, with many companies playing in the field. The FSB should be very careful in designating a certain product or market as “critical” if it chooses to go ahead with this method of analysis.

Question six asks whether “…the framework is flexible enough to cover the different types of business undertaken by G-SIIs?” The Document, like the Basic Capital Requirements for G-SIIs finalized by the IAIS on October 23, 2014, fails to calibrate correctly for the riskiness of various insurance (and non-insurance) activities within an insurance group. For example, Document’s suggestion of potentially problematic activities appears more focused on the life side of the industry than the property and casualty sector. A “driver of criticality,” as the Document styles it, are “sectors which require long-term financing, in which insurers may have a bigger presence….” Long-term investment, naturally, is more typically held in a life insurance investment portfolio than a property and casualty one. The same is true of the Document’s stated concerns about the potential disappearance of insurers who take “long-duration risk in derivatives markets.” And the Document’s concern about insurance as “integrated with essentially savings products,” makes sense in the context of the life industry, not the property and casualty business. It is true that some property and casualty insurers hold long-term portfolios to cover some risks, in particular workers’ compensation claims, but those investments pale in comparison to the amount invested long-terms by the life industry. While important to the financial sector, property and casualty insurers do not play the same role in the financing markets as their life insurance brethren.

We appreciate the opportunity to provide comments on the Document, and look forward to working with the FSB as it refines this paper.