FINANCIAL STABILITY (EX) TASK FORCE

Financial Stability (EX) Task Force Nov. 19, 2015, Minutes
Financial Stability (EX) Task Force Oct. 2, 2015, Minutes (Attachment One)
2016 Proposed Charges (Attachment One-A)
Draft Pending Adoption

Draft: 12/8/15

Financial Stability (EX) Task Force
National Harbor, Maryland
November 19, 2015

The Financial Stability (EX) Task Force met in National Harbor, MD, Nov. 19, 2015. The following Task Force members participated: Peter Hartt, Chair (NJ); David Mattax, Vice Chair (TX); Dave Jones represented by Susan Bernard (CA); Kevin M. McCarty represented by David Aitmaier (FL); Ralph T. Hudgens represented by Mark Ossi (GA); Daniel R. Judson represented by Robert Macular (MA); John M. Huff (MO); Amy L. Parks represented by Omar Akel (NV); Anthony Albanese represented by Martha Lees (NY); Teresa D. Miller represented by Steve Johnson (PA); and Joseph Torti III (RI).

1. **Adopted its Oct. 2 and Summer National Meeting Minutes**

   Commissioner Mattax made a motion, seconded by Director Hartt, to adopt the Task Force’s Oct. 2 and Aug. 15 minutes (see NAIC Proceedings - Summer 2015, Financial Stability (EX) Task Force minutes). The motion passed.

   The Oct. 2 minutes included adoption of the Task Force’s 2016 Proposed Charges.

2. **Heard an Update on International Activities**

   Director Hartt provided a brief update on some activities of the International Association of Insurance Supervisors (IAIS). He said that on Nov. 3, the Financial Stability Board (FSB), in consultation with the IAIS and national authorities, identified nine insurers as global systemically important insurers (G-SIIs). The FSB’s current G-SII list is a result of the third assessment of G-SII status of insurers, in what is anticipated to be an annual exercise. The three U.S. insurers identified as G-SIIs are AIG, MetLife and Prudential Financial. The foreign firms identified as G-SIIs are Allianz, Aegon, Aviva, Axa, Ping An Insurance Company of China and Prudential (UK). Director Hartt added that Generali is no longer designated a G-SII and that Aegon is now on the G-SII list for the first time as compared to last year. The FSB postponed a decision on the G-SII status of, and appropriate risk mitigating measures, for major reinsurers pending further refinement of the G-SII assessment methodology.

   Director Hartt reported that the update to the G-SII assessment methodology and clarification of whether activities and products could be classified as non-traditional non-insurance (NTNI) are a priority for the IAIS. The IAIS plans to revisit the G-SII assessment methodology every three years to see where improvements can be made. Director Hartt noted that the current review has yielded some proposed improvements in several areas that address double counting and anomalies that result from a formula based on a relative ranking of insurers, as well as spells out in greater detail the role of supervisory judgment. There are also several areas where additional stakeholder input will be sought, including as it relates to reinsurance. Both the work on the G-SII assessment methodology and the NTNI framework are expected to be released for consultation in late November, with a 60-day comment period.

   Director Hartt reported that the Financial Stability Oversight Council (FSOC) met twice since the Summer National Meeting. At the last FSOC meeting in early November, the FSOC met in open session and discussed its work on examining potential risks and regulatory developments in the asset management industry, as well as the work of the federal government relating to cybersecurity in the financial sector.

   Director Hartt provided a brief update on the IAIS Resolution Working Group (Working Group), which has held two meetings and several calls since the Summer National Meeting. He highlighted three items. First, the Working Group is providing input to the revised insurance core principles (ICPs) relevant to resolution. The adoption of the revised ICPs is planned for the fourth quarter of 2016. Second, the Working Group is considering whether crisis management groups should be established for all internationally active insurance groups (IAIGs). Third, the Working Group is analysing the applicability of loss absorbency capacity for G-SIIs in resolution, which is intended to ensure that a systemically important financial institution (SIFI) has adequate capital for an orderly resolution. The Working Group will make a recommendation in 2016 on whether total loss absorbency capacity should be applied to insurers or whether existing approaches to resolution are sufficient. A stakeholder meeting regarding loss absorbency capacity will be held in January 2016 in Basel, Switzerland.

   Director Hartt reported that on Nov. 3, the FSB issued a consultation document on developing effective resolution strategies and plans for G-SIIs. Director Hartt noted that the consultation document lists eight questions for public consultation and covers four areas: 1) objectives of resolution strategies; 2) determination of preferred strategy; 3) strategic analysis underlying the development of the strategy; and 4) implementation of the strategy. The consultation period will end Jan. 4, 2016. The Receivership and Insolvency (E) Task Force is currently reviewing the FSB consultation document and may provide comments.

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Director Hartt added that the FSB non-bank non-insurer (NBNI) work stream is considering approaches to identify systemically important financial firms other than banking and insurance firms known as NBNI global systemically important financial institutions (G-SIFIs). In particular, the NBNI’s work encompasses—among other types of firms—broker dealers, finance companies, asset management entities and investment funds, including investment funds managed for third parties by an asset manager subsidiary/affiliate of an insurer. Completion of the methodologies to identify NBNI G-SIFIs is expected in the spring of 2016.

3. Discussed Insurance Risk: Systemic Implications

Mary Weiss (Temple University) provided an overview of the academic literature citing Martin Eling (Institute of Insurance Economics – University of St. Gallen) and David Pankoke (Institute of Insurance Economics – University of St. Gallen), who reviewed 43 papers on systemic risk including insurance. According to the authors, traditional insurance activities are idiosyncratic, not correlated with each other and not influenced by economic cycles. Professor Weiss added that the authors concluded that there is no contribution to systemic risk associated with traditional underwriting and investing activities of insurers. Professor Weiss said that there is no universally accepted definition of systemic risk and thus many measures of systemic risk do not differentiate between instigators of a crisis and victims of a crisis. Professor Weiss noted that insurers are not systemic based on the FSB’s criteria of size, interconnectedness, and substitutability. Moreover, in the U.S., the guaranty funds have been able to absorb losses from the insolvency of some large insurance companies. However, Professor Weiss cautioned those comments with two caveats: 1) an unprecedented crisis within the life insurance industry could challenge the solvency of the guaranty fund system; and 2) life insurers selling group annuities or dealing with large corporate clients who control large blocks of assets could be subject to sudden withdrawals during a financial crisis.

Professor Weiss said that some non-traditional activities may be systemic, including securities lending, life insurer products with guarantees, asset-liability mismatching, reliance on short-term funding, providing financial guarantees, and trading of credit default swaps. Professor Weiss added that Scott E. Harrington (The Wharton School – University of Pennsylvania) argued that AIG was heavily exposed to the subprime crisis and the bursting of the housing price bubble, but whether AIG’s credit default swap portfolio and securities lending actually presented significant risk of contagion has been and will be debated. To the extent consumers continue to purchase insurance, the large cash flow from premiums that needs to be invested could provide a stabilizing force during a financial crisis. Professor Weiss noted that American life insurers were able to raise capital through stock issuance and by cutting dividends throughout the last financial crisis. Thus, extension of the Troubled Asset Relief Program to insurers was unnecessary. The insurance industry weathered the financial crisis well as earnings and capitalization quickly returned to their pre-crisis levels.

Professor Weiss cited a study by Sojung Carol Park (Seoul National University) and Xiaoying Xie (California State University) on reinsurance that show that even under an extreme assumption of a 100% reinsurance recoverable default by one of the top three global reinsurers, only 1% of insurers would become insolvent (and 2% would be downgraded). In her research, Professor Weiss examined reinsurance bi-lateral counterparty relationships using network analysis. The failure of the world’s top five group affiliated insurers in the reinsurance network would be a serious event for the P/C industry with a surplus loss of more than 11% based on a loss given default of 30%, but in other scenarios, reinsurance failures have less impact.

Director Hartt asked if there are steps that regulators could take to further mitigate systemic risk to the extent it actually exists. Professor Weiss responded that there is some macro-prudential supervision taking place, but if there were true macro-prudential regulations implemented, that would go a long way to mitigate systemic risk. State insurance regulators typically ensure legal entity solvency on a micro-prudential level, but if there were an approach that reviewed all risks across the entire firm that would be helpful to assess for potential dangers.

Mr. Altmaier asked if Professor Weiss had any thoughts or comments to the extent that the insurance industry is better prepared for the next financial crisis than it was in 2007. Professor Weiss responded that some of the practices that caused the financial crisis such as securities lending have already been curtailed back, but cautioned that it is unclear what the next loophole will be that some firms may take advantage of to get a better yield to offer more competitive products. Professor Weiss added that the same activity should be treated similarly regardless if performed by a bank or insurer to avoid regulatory arbitrage, which could otherwise result in the next financial crisis.
4. Discussed Funding Agreement-Backed Securities

Stephane Verani (Federal Reserve Board—FRB) noted that there was a run on money market mutual funds by cash investors during the last financial crisis. Mr. Verani added that the life insurance industry is connected more in this shadow banking chain than it was 20 years ago. Mr. Verani said that the traditional business model of life insurers matches long-term, illiquid liabilities with safe assets of similar duration, which is essentially the opposite of traditional banking. The profitability of the business model relies on high returns on safe assets with low capital requirements. The challenges to the business model include falling interest rates combined with higher capital requirements. With profitability under pressure since the late 1980s, life insurers responded in three ways: 1) shifted risks to off-balance sheet captives; 2) engaged in securities lending by earning a spread on the cash received for the lent securities; and 3) increased reliance on funding assets with institutional funding agreements.

Mr. Verani reported on how funding agreement-backed securities (FABS) worked. The life insurer sells a funding agreement to a special purpose vehicle (SPV) located, for example, in the Cayman Islands. The SPV finances the purchase of the funding agreements by issuing notes to institutional investors and then passes on the cash raised back to the life insurer. The life insurer can then purchase certain assets with this cash.

FABS are insurance contracts, and the SPV thus has a claim on the entire general account. The SPV notes are more senior than all debt of the life insurer. Through credit enhancements, AA-rated life insurers could have funding costs of AAA ratings and then invest in BBB securities to generate a substantial yield of 10% to 20%. FABS can be geared to different segments of capital markets from short-term to long-term investors. In 2006, FABS issuance reached a peak of at least $50 billion, and the amount outstanding reached $170 billion. The FABS market was roughly the same size as the auto asset-backed securities market at the same time.

Mr. Verani stressed that in his view, FABS may amplify vulnerabilities to the financial system because it increases the connection between life insurers and the rest of the financial system. As the maturity of FABS decreases, the vulnerabilities of insurers to the financial system will be amplified. Shocks to insurers or institutional investors could trigger a run as initial withdrawals could cause a panic and lead to more withdrawals. The effect of the run will depend on the availability of liquidity.

Life insurers are rarely insolvent, but illiquidity of a life insurer could lead to delays in payments. The delays in payments even for a few days could be highly disruptive to wholesale funding markets. Mr. Verani added that the short-term FABS market was $25 billion in 2007. During the last financial crisis, there was a run on extendible FABS, which are FABS with an embedded put option allowing investors to extend the maturity of the note. The typical investor is a money market mutual fund that is unable to hold the FABS for the five-year maturity, but with the embedded put option, the expectation of the insurance company is that the money market mutual fund will extend to the five-year maturity. In July 2007, money market mutual funds refused to extend the maturity of the FABS. While the effect of the FABS run is hard to measure, the insurance industry found a source of liquidity from the Federal Home Loan Bank (FHLB) system. Those insurance companies that were subject to FABS runs started issuing FABS to the FHLB system. The FHLB system became an important source of liquidity for some insurance companies and over time has become a more significant source of funding. Mr. Verani concluded that three-quarters of FABS withdrawals were due to panic instead of fundamentals.

Director Hartt asked Mr. Verani if he is seeing a move by insurers to modify those transactions to reduce or eliminate the features that create the potential systemic concerns. Mr. Verani responded that the Federal Reserve lacks the data to answer that question, but the market is a lot smaller than before the crisis, and there has been a migration from capital markets to the FHLB system.

Commissioner Mattax asked Mr. Verani if he knew what types of collateral are being pledged by the insurer to the FHLB system and how is that affecting other assets of the insurer. Mr. Verani responded that the FHLB system requires that the advance be fully collateralized usually by mortgage backed securities or other assets from the general account of the insurance company.

Commissioner Mattax asked Mr. Verani that if the high end amount of FABS is 20% of general account assets, is there a specific percent where solvency is impacted. Mr. Verani responded that maturity of the FABS is important with shorter maturity being much more risky, because of a potential impact on liquidity.
5. Discussed Insurance Supervision and Collaboration with the Federal Reserve

Tom Sullivan (FRB) said that the FRB shares the NAIC’s goal of financial stability and is committed to working with the NAIC in a collaborative fashion to promote financial stability, but it has a distinct perspective as a consolidated supervisor of certain insurers. He added that the Federal Reserve is charged with regulating insurers who own thrift holding companies and those that were designated by FSOC. The firms for which the Federal Reserve is the consolidated supervisor hold about $3 trillion in assets, or one-third of insurance industry assets. He noted that the FRB’s principal supervisory objectives include protecting the safety and soundness of the consolidated firm and their subsidiary depository institutions as well as mitigating financial stability risk. In his view, the FRB supplements existing legal entity supervision by state insurance regulators with a perspective that considers the risk across the entire firm.

Mr. Sullivan added that the FRB’s mission is to ensure that the supervised insurers remain solvent as going concerns and maintain their role as financial intermediaries even in times of stress. Mr. Sullivan noted that in case a resolution is required, the Federal Reserve would seek to ensure that the insurer is resolved in a manner that is not destabilizing to the financial system. He reported that the Federal Reserve has met with a number of state insurance departments concerning supervision of insurers and hosted a number of crisis management groups. Mr. Sullivan cited Own Risk and Solvency Assessment (ORSA) as an example of an NAIC tool that would be useful for consolidated supervision.

Mr. Sullivan noted that the Federal Reserve will be active at the IAIS in developing standards for internationally active insurers. Mr. Sullivan stressed that consistent global regulatory standards can help limit regulatory arbitrage. While respectful of each agency’s regulatory authority, the Federal Reserve strives for a consensus U.S. position with the NAIC and the Federal Insurance Office (FIO) on global insurance policy. Mr. Sullivan noted that the Federal Reserve will work collaboratively on standards that are consistent across jurisdiction and appropriate for U.S. internationally active insurance groups. He added that the Federal Reserve Board will cooperate with the NAIC on the U.S./EU dialogue project to determine the way forward to achieve effective supervision of insurance in a way that is appropriate for the U.S. market.

Director Hartt asked about the timeline for G-SII policy measures and expectations on how state insurance regulators should be involved in implementation. Mr. Sullivan responded that first and foremost on the Federal Reserve’s agenda is compliance with the law, in particular mandate 165 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that requires building a domestic regulatory framework. The Federal Reserve has not enacted any policy measures yet but could do so by releasing rules in response to implementation of IAIS standards. If the Federal Reserve were to issue any rules, it would have to follow a certain protocol, including a 60-day public comment period.

Director Huff asked if there are any areas of anticipated conflict between state insurance regulators and the Federal Reserve with respect to regulations of the insurance industry. Mr. Sullivan responded that the Federal Reserve has been highly deferential to state insurance regulators and, in particular, as it relates to insurers with savings and loan (S&L) subsidiaries. There is less regulatory intensity by the Federal Reserve concerning supervision of insurers with S&L subsidiaries than the three designated firms.

Having no further business, the Financial Stability (EX) Task Force adjourned.
The Financial Stability (EX) Task Force conducted an e-vote, which concluded Oct. 2, 2015. The following Task Force members participated: Peter Hartt, Chair (NJ); David Mattax, Vice Chair (TX) represented by Doug Slape; Dave Jones represented by Camilo Pizarro (CA); Kevin M. McCarty represented by Christina Huff (FL); John M. Huff (MO); Amy L. Parks represented by Omar Akel (NV); Teresa D. Miller represented by Steve Johnson (PA); Anne Melissa Dowling (IL); and Joseph Torti III (RI).

1. **Adopted its 2016 Proposed Charges**

A majority of members participating voted to adopt the Task Force’s 2016 Proposed Charges (Attachment One-A).

Having no further business, the Financial Stability (EX) Task Force adjourned.
2016 PROPOSED CHARGES

FINANCIAL STABILITY (EX) TASK FORCE

Adopted by the Financial Stability (EX) Task Force – October 6, 2015

The mission of the Financial Stability (EX) Task Force is to consider issues concerning domestic or global financial stability as they pertain to the role of state insurance regulators.

Ongoing Support of NAIC Program, Products or Services

1. The Financial Stability (EX) Task Force will:
   A. Consider issues concerning domestic or global financial stability as they pertain to the role of state insurance regulators and make recommendations to the International Insurance Relations (G) Committee, the Government Relations (EX) Leadership Council or the International Insurance Relations (EX) Leadership Group, as appropriate.—Essential.
   B. Consider state insurance regulators’ input to national and international discussions on macro-financial vulnerabilities affecting the insurance sector.—Essential.
   C. Serve as a forum to coordinate state insurance regulators’ perspective on a wide variety of issues arising from the designation of U.S. insurance groups as “systemically important” both pre- and post-designation, including:—Essential.
      1. Where appropriate, develop policy recommendations and/or guidance regarding the role, responsibilities and activities of state insurance regulators in the context of consolidated supervision resulting from designation.
      2. Analyze proposed rules by the federal agencies that relate to financial stability.
      3. Analyze proposed policy measures regarding supervisory standards for globally systemic important insurers.
      4. Develop comment letters on such analysis for further consideration by the International Insurance Relations (G) Committee, Government Relations (EX) Leadership Council or the International Insurance Relations (EX) Leadership Group, as appropriate.

NAIC Support Staff: Elise Liebers/Todd Sells/Mark Sagat