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Systemically Important Financial Institutions

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The discussion about which, if any, insurers should be considered systemically important (SIFIs) has been ongoing for several years. No one wants to be labeled as systemically important due to the increased regulatory oversight. The regulators chosen have little understanding of insurance risk, let alone experience, so you never hear anyone suggest that risk is reduced if listed as SIFI. They seem to choose SIFI members mainly on size. That's too bad, because there is a great opportunity to look at risk across financial institutions and what actually could drive the system under. Hopefully this will change as time elapses.

Identifying systemically important institutions based on size is unlikely to reduce the risk but the FSOC will develop its own bureaucracy over time. Regulators would be better off hiring experienced risk managers who can interpret complex models as well as qualitatively consider risk combinations. Only time will tell if regulators and companies have learned from past experience and improved their risk management practices going forward.

AIG nearly took down the world economy in 2008, so they can't (and haven't) argued against the designation. Insurance regulators have long argued, correctly in my view, that the parts of the company regulated as insurance companies had minimal problems at that time. This isn't totally correct, as the asset mix within the companies was tied up with the financial products division, but it is a moot point. They were the poster child for corporate cultural malfeasance. Their leadership believed that they knew best. What I struggle with about AIG is, what has changed? They did not change their name to wipe away the past, and the employees I have encountered do not seem to think they did anything wrong. That seems to be a symptom of the banks working from New York as well, which does not give me confidence going forward.

Met Life and Prudential were also named to the SIFI list. I have often spoken of culture at larger companies as a problem because the survivors that make it to the top leadership team actually think they are smarter than everyone else. Few have data to support this. I would include this class of company as SIFI mainly because they make the same dumb mistakes everyone else makes, but the smaller companies feel the need to follow their leaders. This means that a product design flaw, through contagion, would become an industry flaw. So while it is not specifically their fault that everyone else is a copycat it makes sense to list them as a SIFI. Large companies with closed blocks, or with niche products that are not in the mainstream, should not be listed as SIFIs.

I have argued for several years that the group of insurers that should be considered for the SIFI designation due to their correlation within the industry is reinsurers. Probably not all of them, since some focus on liability risks like mortality, catastrophic or morbidity only, but the interactions between reinsurers through cross-ownership and retrocessions (where a reinsurer shares the risk with others above a certain level) could be a problem. I worried about this with Berkshire Hathaway in 2009 when it became more involved with several European insurers. Warren Buffett has argued against Berkshire being included. But his investment comments, arguing that you should view a firm as if an idiot was running it, may come back to bite him in this instance. While he continues to hold at least $20 billion in liquidity for large claims, there is no requirement for Berkshire to do so. If he were to divest from the financial sector, especially external insurance firms, that would help reduce the contagion risk. The other subsidiaries pose much less risk to the financial system.

Scenario Testing

Each year in the fall I suggest a set of scenarios that should be tested as part of reserve adequacy (cash flow) testing. This year I suggest the following:

- NY 7 without floors (allows negative rates, parallel shifts)
- Spike in rates of 10% over 3 years or less
- Pandemic spike in mortality of .5%
- High credit risk – double default rate for BIG
- Equities – down 35%
- Indexed products – report separately including options, test derivative market failure
- Global climate change scenario – qualitatively assess markets, suppliers

Look at stress scenarios qualitatively and graphically in addition to quantitative focus. Consider a combination of several deterministic scenarios, including one where the Wall Street tool kit is not available.

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