"The Financial Crisis, Systemic Risk, and The Future of Insurance Regulation"
Scott E. Harrington
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Synopsis by John Seigfreid

Scott E. Harrington's article can be described as an in-depth investigation into the implications for insurance regulation resulting from the 2007-2009 financial crisis. The problem addressed is whether insurers inherently possess a measure of systemic risk that contributed to the crisis. To determine this, the author analyzes the interdependencies or, "interconnectedness" of AIG amongst other firms. Accordingly, Harrington addresses whether a systemic risk regulator would be beneficial for insurers? Harrington begins by cataloging the primary causes of the financial crisis and proceeds to dissect AIG's complex organizational structure. Harrington confirms that written financial products predominantly caused AIG's dilemma, rather than insurance products written by regulated insurance subsidiaries. In turn, Harrington concludes his article with an argument against the presence of a systemic risk regulator.

Background

AIG's dramatic collapse left the indelible impression that insurance was an integral part of the crisis. Nevertheless, AIG was not the sole insurance company that was pigeonholed as a contributor to the crisis. Daniel Schwarcz and Steven L. Schwarcz note, "an entire segment of the insurance industry, specifically the financial-guarantee insurers, dramatically destabilized financial markets as it became clear that these insurers would be unable to pay claims on policies insuring against the default of mortgage backed securities."[1] Yet Harrington asserts that, "the insurance sector as a whole was largely and perhaps remarkably on the periphery of the crisis." The misconception could be attributed to the complexity involved with exchanging risk between large-scale insurance firms and their counterparties. AIG's downfall was primarily influenced by credit default swaps (CDS) written by AIG financial products (AIGFP) and its life insurance subsidiaries' securities lending program. These departments are distinct from AIG's lines of business that offer insurance products written by regulated insurance subsidiaries.

AIGFP was a major player in the CDS market place and had $533 billion of CDS outstanding by the end of 2007. These CDSs were frequently sold to E.U. banks that used the extra protection as a way to evade capital requirements for holding the underlying securities enforced by the first Basel agreement. According to AIG's internal credit risk model, the risk of these CDS was negligible. As housing prices began declining and defaults of subprime mortgages increased through 2008, AIG needed to post increasing amounts of collateral with its multi-sector CDO swap portfolio counterparties. As a result, there was an enormous amount of risk on AIG if the underlying securities experienced a sharp devaluation. As we now know, "the contracts clearly were not backed by anything close to the amount of capital

[1]See Schwarcz, Daniel, and Steven Schwarcz

that would have been needed to respond to reductions in the value of the underlying securities and collateral calls by counterparties."[2]

Although AIG's AIGFP division was a major influence in the company's demise, it was not the sole culprit. At the time, AIG was also threatened by "billions of dollars of collateral calls under its securities lending program associated with its domestic life insurance subsidiaries." As assets continued to decline during 2007 and 2008 there was a massive reduction in the values of reinvested collateral in various securities lending programs. Consequently, borrowers canceled transactions to reduce risk exposure and improve liquidity. Undeniably this program heightened solvency concerns for the holding company. It was primarily AIG's AIGFP program in conjunction with its securities lending program that thoroughly dismantled the firm.

Insurers and Systemic Risks

Before labeling major insurance firms systemic risk threats, it is necessary to examine the effect of their interconnectedness. Harrington explains that it is difficult to know how the counterparties hedged their exposure to AIG or mitigated their overall risk. Thus, it is unclear how AIG's subsidiaries diversified their exposure to CDSs. Goldman Sachs, for instance, reported that its exposure to an AIG default was negligible. Whether or not AIG possessed an inherent amount of systemic risk cannot be fully determined without detailed knowledge of its subsidiaries complex investment history prior, and during, the crisis.

Harrington follows his skepticism of AIG's systemic risk with a broader question. Specifically, do insurance companies, in general, pose systemic risk? He argues that for the most part, insurers hold larger amounts of capital compared to their liabilities. As a result, the insurance market is more resilient to shocks relative to banking. Accordingly, insurance firms do not require the same level of government guarantees to prevent "potentially widespread runs that would destabilize the economy." Despite these facts, the U.S. Treasury released a white paper in 2009 "attributing much of the blame for the financial crisis on the failure of large, highly leveraged, and interconnected financial firms, such as AIG."[3] In the face of such scrutiny it becomes justified to ask, is a systemic risk regulator desirable?

Since the financial crisis there has been numerous regulatory reform proposals aimed at reducing systemic risk. After the white paper was released, the Treasury proposed Title V-Office of National Insurance Act of 2009, for creating the Office of National Insurance (ONI) to monitor all aspects of the insurance industry. This proposed legislation was intended to establish a regulator with subpoena power to collect and analyze information on the insurance industry. Following this proposal, members of congress presented "The National Insurance Consumer Protection Act." This bill's primary purpose was to establish an ONI within Treasury to regulate insurers that chose federal regulation. The bill requires the president to designate a federal agency to be a systemic risk regulator that can mandate an insurer to become federally chartered.

According to Harrington, a systemic risk regulator could have several damaging implications. For example, any institution deemed as "systemically significant" would be regarded as to big to fail (TBTF). With this designation comes a reduction in market discipline and increase in moral hazard induced risk-taking activities. If a company were considered

[2]See Harrington 791

[3]See Goodwin Proctor LLP, 2009

TBTF by the systemic risk regulator, the regulating agency would likely have an incentive to help the institution in times of financial distress. This could promote reckless behavior, increasing the probability of future financial problems. Critics refute this argument by using AIG's meltdown as the quintessential example for why a risk regulator is needed. However, Harrington asserts that these critics are ignoring the regulated insurance sectors' comparatively modest role in the crisis.

The aforementioned legislation claims that if the federal government would have to intervene in times of severe financial hardship, then it should have regulatory authority over such institutions. In addition, competing insurance corporations should have the option to choose federal regulation over state regulation. As expressed earlier, Harrington argues that AIG's collapse was not a byproduct of any insurance regulatory failure. It's more than possible that AIG would have met its obligations to policyholders without federal intervention. It is unreasonable to expand the scope of regulatory authority without proper justification. As of now, there is not any convincing evidence that federal regulation of AIG's insurance operations would have prevented excessive risk taking because, of course, insurance firms are predominately regulated at the state level. After reexamining AIG's involvement, it becomes clear that the crisis and intervention do not fundamentally strengthen arguments for a systemic risk regulator or optional federal regulation for insurance.

New legislation and regulation should aim to strengthen bank capital regulation and encourage market discipline in banking, insurance, and other financial institutions. Harrington believes that regulatory agencies should avoid further extension of explicit or implicit TBTF policies beyond banking. The creation of a systemic risk regulator unnecessarily expands federal authority, which will undermine market discipline and ultimately promote conflicts of interest.

References

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