NEWSSTAND

Financial Services Regulatory Reform's Impact on the Insurance Industry: Food for Thought

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Insurers and reinsurers will be impacted directly and indirectly by proposals to modernize regulation of the financial services industry so as to prevent or soften the impact of future financial crises. Even, if new regulators and new powers and authority granted to existing regulators are not targeted directly at the insurance business, subsidiaries, customers, counterparties, service providers, lenders and investors of, to and in the insurance industry will be.

The new landscape of the financial services industry can be expected to force insurers and reinsurers to manage their business more effectively for systemic risks and implement strategic risk management initiatives. In a worst case scenario, insurance holding companies will divest commercial banking and securities businesses and assets, global financial services firms will separate or spin-off their US operations from their global operations, US insurers will seek to new production channels and/or the transfer of insurance risks to the capital markets will become more costly.

As 2010 began, there appeared to be less focus on federal regulation of insurance in the US. Regulators and Congress for some time have been more concerned with the health of commercial banks and investment banks, and professed little interest in tinkering with the relatively healthy insurance industry. During most of 2009, Congress and the Obama Administration were also forced to prioritize agenda items in the push to enact broad healthcare reform and induce economic recovery. However, healthcare reform may no longer be front-and-center given recent political developments in the 2009 state elections and the Massachusetts special election for the late Sen. Kennedy's seat. Meaningful financial services regulatory reform will get much attention in 2010 and insurers and reinsurers should expect some scrutiny of their roles in the industry.
Despite the very public fall of AIG and the near meltdown of the financial services industry in the last two quarters of 2008, the global insurance industry as a whole appears to have weathered the last two years in remarkably good shape. The other two ingredients of the financial services industry, commercial banking and investment banking, have not fared as well.

Commercial banks and investment banks have teetered on the edge of insolvency due to liquidity concerns, trading losses and deteriorating consumer and commercial loan portfolios. Some like Lehman Brothers and IndyMac did not survive. Others like Bear Stearns, Merrill Lynch and Wachovia have been forced into shotgun marriages with "stronger" firms like JPMorgan, Bank of America and Wells Fargo. Most commercial banks and investment banks in the US and

Europe received and, in some cases, were forced to accept, government support whether through direct investment, such as the takeover of Royal Bank of Scotland by the British government, or through government loans and guaranties, such as TARP and commercial paper backstops provided by US bank regulators.

The growing appetite of governments and regulators to exercise control and oversight over the operations of financial services firms suggests that they will continue to play an active role in directing financial services firms. Insurers and reinsurers should be wary about the long-term implications of greater government involvement in and control of financial services firms and be prepared to live within new constraints and take advantage of new opportunities created by limitations on the operations of other financial services firms.

Clearly, the insurance industry has been challenged particularly by large losses in its investment portfolio. Yet, populist furor in the US has for the most part focused on the compensation excesses and reckless risk-taking of Wall Street and large commercial banks. Indeed, Congress, regulators and the press have generally lauded insurers and reinsurers for being immune or at least resistant to the malaise and ill-health of commercial banks and investment banks. Despite this goodwill towards the insurance industry, since mid-2009 there have been loud calls in the US and Europe to dramatically overhaul the regulation of the financial services industry within which insurers and reinsurers are inextricably entwined. Changes in law intended to address perceived abuses that precipitated the recession of the last two years and therefore prevent future instability of the global financial services system will clearly impact the insurance industry.

There have been a number of recipes for financial services reform advanced in the US over the last year. In June 2009, President Barack Obama and the US Treasury, under the new leadership of Timothy Geithner, proposed a broad overhaul that, among other matters, focused on regulation of systemic risk.1 Others have called for reinstating some or all of the Depression-era barriers among insurers, banks and securities firms.2 This unscrambling of the omelet that the financial services industry has become over the last decade may, depending on its scope, create major challenges to some insurers and reinsurers.

The insurance industry has much at stake as legislators and regulators begin to formulate a new approach to the regulation of the financial services industry. Insurance holding companies that own banks, securities firms, investment banks and commercial lenders face uncertainties as to new restrictions and perhaps outright prohibition on certain activities. Many insurers rely on producers owned by bank holding companies or investment banks to deliver personal lines products like auto and homeowners insurance, life and annuity policies, and commercial coverages to small and medium-sized businesses. Limitations on ownership or activities of such producers could impact premium volume. Lastly, the forced divestiture by financial services firms, including insurers and reinsurers, of certain financial services businesses could dramatically erode profitability and capital.

It is unlikely that Congress will completely turn back the clock to a pre-Gramm-Leach-Bliley era, but it is worth reviewing how different the financial services industry was at that time because there will continue to be calls to bring back some of limitations on affiliations of insurers, commercial banks and investment banks, and permitted activities by each.

Before the adoption of the Gramm-Leach-Bliley Act (GLB), commercial banks were prohibited under federal and many state laws from engaging in most insurance activities or being affiliated with insurers. This of course meant that a bank holding company could not only own an insurance company, but that an insurance holding company could not own a bank. Banks were extremely limited as to insurance brokerage activities, generally being permitted to sell only property and casualty and life insurance products in connection with credit transactions to provide for repayment of loans.

While generally there were few restrictions on the affiliation of insurers and securities firms, the Glass-Steagall Act, which was repealed by GLB, did not permit commercial banks to engage in or be affiliated with securities firms engaged in underwriting securities. It seems quite likely that Glass-Steagall barriers will be re-erected in part.

What Might Some of the Impacts on the Insurance Industry Be?

If those in the US calling for a separation of commercial banking, insurance and securities underwriting win the day in whole or in part, insurers like MetLife, who have built successful banking franchises, may have to divest those businesses at a time when there may be fewer buyers or investors interested in the banking business. It may be difficult for insurance firms to recover their investments in banking firms reducing their capital and hampering efforts to pursue business plans and strategies.

In addition, large global firms like Credit Suisse, Swiss Re and Allianz may face difficult decisions to ensure continued access to the US market. Will they be forced to separate or spin-off US insurance, investment banking and commercial banking operations from each other? Such regulatory-driven divestitures may create strategic opportunities for some insurers and reinsurers and may lead to reduced capacity in some markets. Even, if global firms are able to comply with US restrictions through isolating domestic insurance businesses from global banking or securities activities, they will not be able to offer customers a broad menu of services, reducing the value of US operations.

Firms such as Aon, Swiss Re and Allianz have been active in cat bonds and other risk securitizations building on their insurance and investment banking expertise to transfer risk to the capital markets. Efforts to separate insurance and investment banking businesses could make cat bonds more challenging to structure and more expensive to bring to market.

Many of the largest insurance producers in the US today are affiliated with commercial banks and thus important sources of premium volume to insurers. As noted above, commercial banks pre-GLB were limited from selling many lines of insurance. Insurers would have to develop more expensive production channels if banks had to scale back their broker businesses. For example, private banking operations of commercial banks and broker/dealers are key sources of high face life and annuity business to life insurers. If bank or securities firm employees were limited in their ability to hold insurance producer licenses, it would be difficult for banks and insurers to form effective marketing alliances and joint ventures targeting high net worth individuals.

Seemingly industry-neutral regulation of derivatives requiring disclosure and/or registration of transactions may discourage development of proprietary swap structures or impose burdensome margin requirements that may limit the ability of insurers and reinsurers to hedge risks in the capital markets. As a result, the capacity of some insurance markets may be reduced as reinsurers lose the ability to redeploy surplus to support certain insurance lines.

After the financial services industry staggered in 2008, many suggested that flawed approaches to risk management and over-reliance on financial modeling were a root cause of the sudden evaporation of value and disappearance of liquidity. Criticisms were also leveled at ratings agencies for conflicts of interests. Current legislative proposals seek to address both risk management and rating agency regulation. Some form of federal regulation of systemic risk should be expected. It is unclear what approach will be adopted for rating agencies, some have suggested encouraging the establishment of more ratings firms and others regulation to eliminate past economic incentives to grant higher ratings. Regulation of systemic risk is likely to require more detailed reporting by large insurers and reinsurers and more extensive internal risk management structures addressing financial and counterparty exposures. Any changes to the current rating systems may be inconsistent with state laws and regulations and accounting rules relating to admitted assets and risk-based capital. Insurers will be challenged to comply with state laws that rely heavily on ratings of securities at a time when federal regulators may be discounting or questioning ratings. Any substantive change in how ratings agencies operate may require the NAIC's Securities Valuation Office to reconfigure its rating criteria.

For the US insurance industry the next twelve months may well be transformative. Regulation will change, some business may need to be discontinued or divested and relationships with partners, customers and investors may need to be substantially reworked. However, firms may have new opportunities to grow and expand, as their competitors must also deal with the changed landscape.