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The "Resolvability" of a Major Insurer

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The following is an edited version of remarks delivered on the topic of "Consumer Protection Frameworks and Guarantee Funds" at the 20th Annual Conference of the International Association of Insurance Supervisors in Taipei on 18 October 2013. The opinions expressed are solely those of the author and do not necessarily represent the views of NOLHGA or its membership.

When I was an undergraduate, I had the good fortune of meeting and talking with the economist Milton Friedman, who was a longstanding member of our faculty.

A famous classroom teaching practice of his was to respond to a student's observation about how some pattern or practice appeared in the real world by saying, "That's all very well in practice, but how does it work in *theory*?"

Like the Oracle at Delphi in ancient Greece, Professor Friedman sometimes offered cryptic statements that were susceptible of misunderstanding, and this question was like that.

It was interpreted by students in one of two ways:

Some students took it as an assertion that the study of economics—and perhaps even the development of economic policy—was properly concerned more with pure theory than with the empirical lessons presented by transactions and experiences in the real world.

They misunderstood Friedman. What he really meant was that one couldn't properly analyse empirical data—and certainly couldn't predict future performance or develop normative economic standards—without a properly functioning organising hypothesis. Such a hypothesis should explain the available empirical data, and certainly should not be *contradicted* by that data.

As I look at some important recent deliberations about insurance regulatory policy, I wonder which way various policymakers would have interpreted Professor Friedman's statement—"That's all very well in practice, but how does it work in *theory*?"

Would they take it as an assertion that pure theory, untethered to reality, is the key driver in policy decisions; or would they take it to mean that our actionable theories should be drawn from and consistent with real-world evidence?

One of the key issues now before makers of insurance regulatory policy is the "resolvability" of large insurance groups under current laws and processes. It is thought that, if such groups are NOT resolvable under current laws and processes, they must be subjected to significantly different regulatory measures and resolution processes.

And indeed, policymakers—internationally and within some key jurisdictions—appear well on their way to concluding that large insurance groups (most of them writers of traditional insurance products) would *not* be resolvable under current systems.

What do we see in the various explanatory documents and findings relating to policymakers' thinking to date on this key issue? What I read and see are conclusions based almost entirely on theories that themselves rest on supposition, speculation, and assumptions about what would happen if a large insurance entity were to fail.

These theories are sometimes elegantly stated and, for the most part, internally consistent. But what I do NOT see is any convincing effort to relate the theories and their corollary assumptions with relevant real-world experience.

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One very proper regulatory initiative since the inception of the financial crisis has been to require large financial entities to conduct "stress tests"—tabletop modeling exercises analysing projected outcomes in hypothetical adverse economic scenarios.

One can learn a lot from such exercises, even though they are only models and only as good as their assumptions.

But it is not widely appreciated that we have just come through a financial crisis—the worst in generations—that was, among other things, the most illuminating and probative "live-fire" stress test that we hope ever to see in our lifetimes.

This real-world stress test showed us much about the regulatory and resolution regimes in place at the start of the crisis.

In the U.S., during the four-year period from the start of 2008 to the end of 2011, we saw over 400 banks and thrifts fail; the largest investment banks *all* failed, were acquired, or reorganised into bank holding companies; Fannie Mae and Freddie Mac went into receivership; a leading money market fund "broke the buck"; two of the top three auto-makers entered bankruptcy; and hundreds of pension plans, hedge funds, and finance companies failed.

And what of the traditional insurance sector? (I speak primarily about the U.S. life insurance market, but the outcomes were substantially similar for general insurance in the U.S. and for both life and general insurance in other countries.)

In the U.S., during that same period (from the start of 2008 until the end of 2011), a grand total of about a half dozen writers of life and annuity business failed. They were all *tiny* companies by the standards of the current regulatory debates. Few of the distinguished insurance experts at this conference would have heard of *any* of them. Their total face amount of liabilities to policyholders amounted to about USD950 *million*—with an "M." Compare that to Lehman Brothers alone, which, when it entered bankruptcy, owed creditors over six hundred *billion*—with a "B". And of that USD950 million owed to consumers, consumers received all but a few million dollars of what they were originally promised.

Stated differently, throughout a financial crisis that rivaled in severity the Great Depression of the early 1930s, the failures of traditional insurance companies did not contribute to (let alone cause) the crisis, and neither were traditional insurers drastically affected by it.[1]

This real-world, live-fire stress test revealed no significant causative connection extending from traditional insurance businesses to the financial economy. If there were systemic issues that manifested themselves in the financial economy in the recent crisis, companies writing conventional insurance products did not cause them. Indeed, a strong case may be made that the insurance sector was an anchor that kept the crisis from getting worse than it did.

There were no "runs on the bank" at major insurers. There was no "contagion" among major insurers. There were no fire sales of assets. Insurers quietly held to their course, as did insurance consumers—in this trying recent period, and indeed, before that, even during the Great Depression, as my friend Terri Vaughan has recently written for The Geneva Association.[2]

I make the following observations about why it is no accident that the traditional insurance sector performed as well as it did in the recent financial crisis.

Harking back to Professor Friedman's challenge—"That's all very well in practice, but how does it work in *theory?*"—these thoughts are offered as an alternative organising hypothesis that not only explains the available empirical evidence, but that is more consistent with that evidence than some other theories recently articulated.

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1 This point is considered generally and at some length in a recent study by the U.S. Government Accountability Office. GAO (2013). *Insurance Markets: Impacts of and Regulatory Response to the 2007-2009 Financial Crisis*. Washington: U.S. Government Accountability Office, June 2013.

2 Vaughan, T. (2012). *Life Insurance: Providing Long-Term Stability in a Volatile World*, discussion paper prepared for The Geneva Association General Assembly, 7 June 2012.

The hypothesis offered here has everything to do with the focus of today's discussion: insurance consumer protection frameworks. The thesis is this:

That well-developed insurance policyholder protection schemes—of which our U.S. guaranty system, I submit, is one—that are well integrated with an effective, broad system of protecting consumers against insurer insolvency—not only can and do work to protect consumers and promote financial stability, but can be expected to do so under any reasonably foreseeable real-world "stress" scenarios.

Policyholder protection schemes must meet certain necessary conditions to function well: those conditions involve, among others, articulation of who and what is covered and the extent of coverage; reliable financing sources; statutory tools for crafting an appropriate resolution plan for a given company's failure; solid processes for developing and implementing a plan; and the human resources needed to do the job.

In one sense, a policyholder protection scheme can be evaluated on the basis of how well it satisfies those necessary conditions. I believe the U.S. guaranty system satisfies them all. The relevant details of the U.S. life and health guaranty system are available at our website, www.nolhga.com.

But beyond those necessary conditions, I submit further that a policyholder protection mechanism can be judged meaningfully only in the context of the *overall* system of insurance consumer protection in its jurisdiction.

U.S. consumers have been well protected over the years not only because we have developed—through trial and error and a lot of challenging experience—an effective policyholder protection scheme—but because several interdependent parts of a *complex* of consumer protection elements combine well to serve the interests of insurance consumers.

Those elements, in brief, are the following:

First, we have a set of established and generally followed business norms for insurer operations that render it highly unlikely that an insurer will fail, even in periods of economic stress. U.S. insurers are not "high fliers"—they are by industry custom and consumer expectation a financially conservative sector that takes seriously the long-term nature of commitments to consumers and the need to underwrite, price, manage, and invest so as to permit performance of the promises the companies make.

Second, we have strong financial regulation that has only gotten better over the years, and that in general does a very good job of requiring the maintenance of appropriately high levels of capital and of spotting and intercepting solvency problems early enough to permit the development of regulatory and resolution plans that minimize and usually eliminate losses to consumers.

Third, we have a well-designed and generally effective framework for administering the resolutions of the few insurers that do fail—a receivership framework that effectively prioritizes the protection of consumers by requiring the application of assets of a failed company to the satisfaction of consumer contracts before assets can be used for any other purpose.

Finally, to the extent that, in those rare cases when companies fail and assets are *insufficient* to satisfy contractual obligations, the guaranty system has, over four decades, and in a number of cases (including companies both large and small) always delivered a guaranteed "floor level" of consumer recoveries that is usually augmented—above that floor level—by substantial recoveries from assets of the failed insurer.

The indisputable factual lesson of the financial crisis regarding traditional U.S. insurance markets is that consumers were well served by the interdependent functioning of those four elements: a conservative industry, strong regulation, effective receivership processes, and a capable, well-designed guaranty system "safety net".

My humble prediction is that consumers can likewise expect to be protected under any reasonably foreseeable future circumstances.