

# [The dodd-frank effect: the insurance industry](https://assignbuster.com/the-dodd-frank-effect-the-insurance-industry/)

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The Dodd-Frank Effect: The Insurance Industry Executive Summary The financial crisis of 2008 was cause by many factors within the United States financial system. Although the actions of insurance companies were not a key factor, they did adversely affect the industry and amplified the downward affect on financial markets. Insurance companies were adversely affected through the devaluation of their investments as a result of the collapsing mortgage market, depletion of capital, and increases in credit default swaps. Some insurance companies improperly managed risk and experienced issues with liquidity as claims and collateral calls were made and subsequent credit rating downgrades ensued. The US government attempted to fix these issues and prevent further failures by creating various federal oversight entities under the Dodd-Frank Act. Dodd-Frank also classifies many insurance companies as Nonbank Financial Companies, which are subject to more stringent regulations. Dodd-Frank takes into account the importance of the insurance industry and adequately made regulatory changes. The solutions to the issues in the Dodd-Frank act should be beneficial in preventing future failures. Problems in the Insurance Industry The financial crisis in 2008 was not largely caused by the actions of insurance companies, but did adversely affect the insurance industry and in certain cases exacerbated the pressures on financial markets. The insurance industry remained relatively stable overall through the crisis even though some insurance firms saw significant losses and required government assistance. The issues were, for the most part, seen in mortgage insurers, life insurers, financial guarantee insurers, and large insurance dominated financial groups. Mortgage insurers were most rapidly hit by the crisis due to mortgage credit risk exposure in the collapsing US mortgage market. The core business model for mortgage insurers is to guarantee financial service companies that their individual or portfolio of mortgages will retain their value. As the value of many mortgages in the market drastically declined the insurers realized significant losses and depletion of capital buffers. Some of the largest US mortgage insurance companies posted significant quarterly and year losses in 2007 and at least one of the ten largest had entered a run-off by 2008. These losses had a greatly adverse effect on share prices of mortgage insurance companies, which lead to a large increase in the price of credit default swaps on the firm. Increases of prices on credit default swaps put downward pressure on financial markets. Life insurance companies were affected in a different manner. Market valuation pressures significantly declined the values of life insurance companies’ investments, specifically in stocks and mortgage-backed securities. Life insurance companies also experienced a rise on the liabilities side of the balance sheet as their variable annuities contracts became increasing expensive to fulfill with deteriorating capital market valuation and low or moderate government bond interest rates. Hedging strategies for these companies drastically increased due to high volatility in the market and further decreased profit margins. Possible credit rating downgrades posed numerous adverse consequences as well. Large financial guarantee insurers lost their triple-A rating during the crisis, which was the core of their business model in essentially renting out their high rating to lower-rated issuers. Financial guarantee insurers also tend to be highly leveraged and when they need to deleverage, as they did during the crisis, they add dislocations in credit markets, amplifying systemic risk. Difficulties experienced by these companies trickled down to the enhancements they provided and negatively affected the banks, other institutions, and markets that relied on the insurance they provided. Thus, the effect exacerbated downward pressure on financial markets. Regulation of these entities was called into question almost immediately, but the entities were regulated on a state-by-state basis and had no clear solution. Insurance dominated financial groups were the largest contributors to the financial crisis in the insurance industry. In addition to normal insurance contracts, these companies offered other financial instruments such as credit default protection through derivatives. The largest of these firms was American International Group (AIG). AIG sold credit default protection in the form of credit default swaps on collateralized debt obligations, such as mortgage-backed securities. These practices proved detrimental to AIG during the crisis, as its risk management was severely insufficient. The risk management model used failed to account for future collateral calls and write-downs. After reporting the highest quarterly loss a US corporation has ever reported and subsequent credit rating downgrade, AIG could not liquidate enough to cover its required collateral. The US government deemed AIG too large and interconnected to allow it to fail. The government provided AIG with the funds to pay off its collateral and buy the underlying assets of credit default swaps in order to retire them1. Regulatory Solutions The Dodd-Frank Wall Street Reform and Consumer Protection Act, also known simply as Dodd-Frank, is an act passed by the US government in order to identify and reduce systemic risk in the US financial system. The act is a large and complex document with 849 pages of specific provisions and regulatory changes to the US financial system. Dodd-Frank has many implications for the insurance industry, but the act focuses mainly on other facets of the financial system. The insurance industry is most affected by Dodd-Frank through the creation of the Financial Stability Oversight Council and the Federal Insurance Office, as well as increased power for the Board of Governors of the Federal Reserve (FRB). Title I of Dodd-Frank involves the creation of the Financial Stability Oversight Council (FSOC), which is comprised of ten voting and five non-voting members. The FSOC identifies risks to financial stability related to large, interconnected bank holding companies, and non-bank financial companies. Also to eliminate expectations that a firm is too large to fail and respond to emerging threats to US financial markets. Insurance and reinsurance activities are financial in nature under the Bank Holding Company Act of 1956 and therefore insurance companies are treated as a non-bank financial company. The FSOC can direct the Fed to regulate an insurance company if its financial position could pose a threat to the financial stability of the United States. This is based on the company’s leverage, off-balance sheet exposures, relationships to other significant financial companies, importance as source of credit or liquidity, asset management, mix of activities, degree of regulation, amount and nature of assets and liabilities, and any other factors deemed relevant. Development of quantitative metrics of risks such as spillover, liquidity, leverage, and regulatory scrutiny are outlined to allow for ease of recognition. Strict standards will also be put into place by the FSOC including risk-based capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure requirements, concentration limits, contingent capital requirements, public disclosures, short-term debt limits, and overall risk management requirements. Although the Board of Governors of the Federal Reserve (the Fed) is mostly under the direction of FSOC it has the authority to gather data and conduct examinations, which extends to all subsidiaries of the insurance or reinsurance holding company. The Office of Financial Research (OFR), under the Treasury, can require reporting from insurers and reinsurers to assess the extent by which a company could pose a threat to the stability of the United States. The OFR collects data, develops models, and provides research and analysis to the FSOC and other agencies2. Title V of Dodd-Frank requires the establishment of a Federal Insurance Office (FIO) within the Treasury to monitor all aspects of the insurance industry (with the exception of health, long-term, and crop insurance) and report to congress and the President with annual reports. The article states that the FIO mandates compliance with FIO requests and specifically outlines interactions with states on international issues. The FIO aids and consults with states on federal and international issues, determines whether state insurance measures meet minimum legal standards, and allows suspension of state rules that prevent fair state access to international insurers. States may also enter a compact with other states regarding premium allocation3. The FIO also actively identifies insurers that may need supervision of the Federal Reserve due to systemic risk2. Issues may be referred by the FIO to the Financial Stability Oversight Council. Criticisms of Solutions In regards to the issues of the insurance industry discussed in the first section of this report the US government responded adequately with the resolutions presented in the DoddFrank Wall Street Reform and Consumer Protection Act. The act addressed the major issues of liquidity and capital requirements of large insurance companies. The FSOC oversees various aspects of the US financial systems, but has an appropriate concentration on insurance companies. The FRB and OFR have more accessibility to insurance companies to ensure transparency of their activities. Dodd-Frank also created the first permanent federal entity entirely focused on the oversight of the insurance market2. These aspects of Dodd-Frank, if implemented and run correctly, should help in deterring future issues within the industry. The Financial Stability Oversight Council consists of one voting member and two nonvoting members with insurance expertise. These experts comprise one fifth of the council and should provide accurate insight into the industry for the council to implement proper regulation on insurance companies. The council may affect state regulation of insurance by recommending new or heightened financial standards allowing state-to-state insurance standards to be more consistent. Insurance companies may be treated as a Nonbank Financial Company, giving the FSOC and FRB greater regulatory oversight of their activities. However, the council must consult with domestic state insurance regulators prior to determining whether an insurance company that qualifies as a Nonbank Financial Company is subject to supervision. This aspect gives a balance between state and federal regulators. If the insurance company is determined to be in need of supervision the standards are potentially more strict than those imposed by its state regulator allowing federal oversight on potentially higher risk companies. Researching authority of the FRB and OFR will result in more accurate reports of insurance company’s financial data including liquidity, leverage, and risk exposure. The data collect will provide indicators that could prevent a situation such as AIG’s in 2007 and 2008 that lead to a major government intervention and a significant adverse effect on financial markets. The Federal Insurance Office is the first permanent federal entity entirely focused on the oversight of the insurance market. This creates an office dedicated specifically to the insurance industry to monitor all activities and report them to higher regulatory authorities. The FIO also focuses on gaps in regulation between federal and state regulation that could contribute to systemic risk. Although the FIO has limited regulatory authority over insurance companies, its ability to assess the effectiveness of state insurance regulation and recommend federal changes could have a major impact in the future of the insurance business4. The Dodd-Frank Act certainly addressed the issues surrounding the 2008 financial crisis in regards to insurance companies. With the multiple authorities now charged with overseeing the insurance industry another major insurance company failure should be negated. Dodd-Frank appropriately allows for regulators to take action when needed, while also fixing the preexisting issues in the industry. 1 — Insurance Companies and the Financial Crisis: Sebastian Schich; http://www. oecd. org/finance/financialmarkets/44260382. pdf 2— 3— 4—