"Life Insurers as SIFIs: A Case of Mistaken Identity?"

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As Prepared for Delivery

Thank you Tom for that kind introduction, and good afternoon everyone.

One of the themes of this year's Capital Markets Summit is how efforts to eradicate risk from the financial system can have serious unintended consequences. Nowhere is that more true than in the U.S. life insurance industry.

We are in the business of insuring against one of the most significant risks that individuals and their families face – the loss of income from death, disability and retirement. Our job is to take on, pool and manage risk, a vital function that individuals cannot perform for themselves. It is also a function where bigger, generally speaking, is better – the larger the risk pool, the more manageable the liabilities.

Under the existing system of state-based insurance regulation, the U.S. life insurance industry has a long history of properly managing risk – in fact, there has never been a systemic event in the traditional insurance space. Now, for the first time in U.S. history, the federal government is proposing to undertake prudential regulation of the life insurance industry – or at least a part of it.

My perspective on systemic risk is informed both by my position as CEO of MetLife and by my own experience as a federal financial regulator. From late 2001 until early 2004, I was the Executive Director of the Pension Benefit Guaranty Corporation, which insures corporate defined benefit pension plans, much as the FDIC insures bank deposits.

At the PBGC, part of my mission was to protect taxpayers from having to bail out the pension insurance fund. So I strongly support the goal of the Dodd-Frank Act, which is to "protect the American taxpayer by ending bailouts." But I was also careful to focus my efforts on those who presented the greatest risk to the pension insurance system. Certain sectors of the economy kept me up at night. Others did not.

Should MetLife keep systemic risk regulators up at night? Should any traditional life insurance company? I hope my remarks today will help answer those questions. I plan to make three main points.

First, the life insurance business did not cause the financial crisis.

Second, imposing bank-centric regulations on certain life insurance companies – however well-intentioned the purpose – would negatively affect the availability and affordability of financial protection for consumers.

And third, there is a better way for the federal government to regulate potentially systemic activities in the life insurance sector than by naming just a handful of companies as Systemically Important Financial Institutions, or SIFIs.

Let's begin.

The Life Insurance Business Did Not Cause the Financial Crisis

In the "Financial Crisis Inquiry Report," the federal government's own 663-page analysis of the causes of the financial crisis, the phrase "life insurance" appears exactly one time. Variants of the word "banking" appear more than 50 times in the first 25 pages. This is not to pick on the banks, whose mission of extending credit is critically important to society. But it is to underscore some of the differences between life insurers and banks from a systemic risk perspective.

Generally speaking, banks borrow short term and lend long term – for example, by taking liquid, short-term deposits and investing in illiquid long-term assets, such as mortgages. Life insurers have a different business model. We generally write long-term policies and invest premium dollars in long-term assets to make good on those obligations when they come due. What banks call maturity transformation we call a maturity mismatch.

Adair Turner, the former chairman of the U.K. Financial Services Authority, said the following in an October 2010 speech: "What we almost never face in insurance is long-term assets held against short-term liabilities, [which is] the defining characteristic of banking and shadow banking and a key source of potential volatility. From that essential difference flows the reason why integrated regulators tend in a crisis to sleep easier at night about their insurance company charges than about their banks."

Liquid liabilities are the kind that can run out the door during a crisis. That's why panicked depositors would line up around U.S. banks to withdraw their money in the days before the FDIC – and why we still see bank runs in parts of the world today. The liabilities of an insurance company are very different. We make payments to customers over many years, as with annuities, or when an insurable event occurs, as with death or disability claims. That is why you won't see a "run on an insurer" the way you see a "run on the bank."

That is also why life insurer insolvencies take place in an orderly manner over time. One of the concerns during the crisis was the tendency for financial firms to "fail messily," as former Federal Reserve Governor Alan Blinder put it. Yet because life insurance liabilities are paid out over time, state insurance supervisors are able to manage the receivership process with a minimum of disruption.

Please note that I am not saying that life insurance companies cannot fail. Nor am I saying that MetLife could never fail. What I am saying is that the traditional business of life insurance does not pose systemic risk.

The Dodd-Frank Act defines a SIFI as a company whose failure "could pose a threat to the financial stability of the United States." The Financial Stability Oversight Council, or FSOC, clarifies that such a threat only exists if "there would be an impairment … of financial market functioning that would be sufficiently severe to inflict significant damage to the broader economy."

Simply put, there is no evidence that any traditional life insurance company meets that test.

The Elephant in the Room

Now, I know what many of you are thinking. What about AIG? Wasn't it an insurance company, and didn't it require the biggest bailout of all during the crisis?

There is no question that the legacy of AIG has "cast a pall over the industry," as the Washington Post recently put it. But AIG's insurance businesses were not the cause of the company's financial distress. AIG's Financial Products division was a shadow bank lightly regulated by the Office of Thrift Supervision, not by state insurance supervisors. As is well known, AIGFP wrote naked credit default swaps on subprime mortgages, and when the housing bubble collapsed, so did the company.

As Andrew Ross Sorkin of the New York Times wrote at the time, "AIG used its triple-A rating from the insurance part of its business to run a huge casino that then overwhelmed the entire business."

To put it another way, AIG's life insurance subsidiaries did not cause the company's financial distress. They were victims of it.

In a recent paper entitled "An Analysis of the AIG Case: Understanding Systemic Risk and Its Relation to Insurance," Etti Baranoff, an associate professor of Insurance and Finance at Virginia Commonwealth University, wrote: "We have indicated that [credit default swaps] are not insurance contracts. It is important to point out that the securities lending activities and investment in [mortgage-backed securities] would not have caused the collapse on their own, as they did not take any other insurer down. In addition, all of AIG's insurance subsidiaries' policyholder claims were paid."

None of this is to deny that regulators should closely examine the activities of life insurance companies. But in my view, there is a better way to accomplish this goal than by potentially singling out three of the nation's 895 life insurance companies for SIFI designation. I will have more to say about this in a few minutes.

Not Systemic

As mentioned, I do not believe the traditional business of life insurance presents systemic risk to the U.S. economy. Nor do I believe that MetLife is a systemically important financial institution.

In a recent analysis, the International Association for the Study of Insurance Economics – commonly known as the Geneva Association – compared the 28 largest global banks and the 28 largest global insurers on potential indicators of systemic risk. The findings are instructive.

Looking at size, as measured by total assets, the largest insurer would rank as only the 22nd largest bank.

Or consider credit default swaps. Gross notional CDS protection sold was $632 billion for the average bank, compared with just $4 billion for the average insurer. For the largest bank, the figure was $2.7 trillion. For the largest insurer, the figure was $23 billion – or less than 1% of the amount sold by the largest bank. There really is no comparison.

With regard to MetLife specifically, I think the data are equally compelling.

In our derivatives book, counterparty exposure to MetLife, net of collateral, is insignificant as a percentage of counterparty total capital. The average exposure in the event of a MetLife default is one-quarter of one percent of a derivative dealer's total capital. The largest exposure is three-quarters of one percent of total capital – simply not large enough to create systemic risk.

Or consider securities lending, where we loan our general account securities to counterparties in exchange for cash collateral that we reinvest to earn extra income. The concern is that in the event of a financial crisis, we might not be able to return the collateral. Our counterparties could be stuck holding securities that have declined precipitously in value, putting their own solvency at risk. This is less of a concern today than it was during the financial crisis. In MetLife's programs, approximately three-quarters of the securities on loan are U.S. Treasuries. During a crisis, Treasuries typically increase in value, which would protect counterparties in the event of a forced sale. It is also important to note that MetLife's securities lending programs are conducted in state-regulated insurance subsidiaries. AIG's program, pre-crisis, was not.

Again, this is not to deny that life insurers may engage in activities that, if not appropriately regulated, are potentially systemic. It is simply to say that, as an institution, we cannot see how we pose a threat to the broader economy – in fact, we cannot see how a single firm would be brought down by its exposure to MetLife.

As David Cummins and Mary Weiss of Temple University observed in a September 2010 paper entitled "Systemic Risk and the U.S. Insurance Sector": "The failure of one financial institution – even a very large one – that does not spread to other institutions and the real economy is not a systemic event."

The Wrong Capital Framework

Which brings me to my second major point.

Under Dodd-Frank, firms designated as non-bank SIFIs will be subject to so-called "enhanced prudential standards." As drafted by the Federal Reserve, these standards are based on the regulatory capital model for banks, where high leverage, illiquid assets and short-term liabilities require large capital cushions to absorb losses.

I recognize that the bank capital framework is familiar to the Fed whereas the state-based insurance capital framework is not, but no amount of "tailoring" will ever make bank capital standards fit a life insurer's balance sheet. Bank capital rules were established to protect depositors. They were not designed to ensure that a life insurance company can meet its long-term policyholder obligations.

Applied literally to a life insurer's balance sheet, Basel III bank capital rules would constrain the availability and affordability of financial protection for consumers. Faced with unnecessarily large capital requirements, life insurers would either have to raise the price of the products they offer, reduce the amount of risk they take on, or stop offering certain products altogether.

As Anna Paulson of the Chicago Fed wrote in a March 2012 presentation, "Insurers are in the business of sharing risk with individuals [and] businesses. Regulation that makes it more expensive for insurers to do this means individuals and firms will [either] hold more risk, or pay more to achieve the same level of insurance."

Let me provide a real-world example. Prior to annuitization, variable annuity assets are held not in a life insurer's general account but in separate accounts where investment gains and losses are borne by the customer. Because these assets show up on our balance sheet under GAAP accounting, a literal application of Basel III would require us to factor them into our capital ratios. In MetLife's case, our risk-weighted assets would more than double and our capital ratios would wither – a result disproportionate to the risk life insurers bear in making variable annuity guarantees. It is hard for me to see how life insurers living under Basel III could remain in the variable annuity business, which would push risk and cost back onto a population in dire need of retirement income solutions.

These are not merely the concerns of a for-profit CEO worried about return on equity and the price of his company's stock. Gina Wilson, CFO of the not-for-profit TIAA-CREF, testified before Congress last November on Basel III, saying, "The proposed capital standards … would have a detrimental effect on insurers' ability to offer affordable financial products, which would in turn trickle down to individuals who utilize insurance products to help them build a more secure financial future."

Measuring the Impact

To test our assumption that higher capital requirements would raise costs for consumers, we asked the consulting firm Oliver Wyman to analyze the impact of applying Basel III banking rules to certain life insurance companies. Because higher capital charges would require affected firms to raise prices or reduce benefits, unaffected competitors would respond by raising prices as well, given their limited capacity. Oliver Wyman estimates that the ultimate cost to consumers would range from approximately $5 billion a year to $8 billion a year, either in the form of higher premiums and fees, or lower retirement benefits.

At a time when government social safety nets are under increasing pressure and corporate pensions are disappearing, sound public policy should preserve and encourage competitively priced financial protection for consumers.

The good news, relatively speaking, is that banking regulators have shown a strong ability in the past to recognize the important differences between banks and insurance companies. For example, in 2001, the National Association of Insurance Commissioners and the Federal Reserve formed a Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage. Let me quote from their report:

"Banking and insurance industry supervisors use very different approaches for identifying and addressing exposure to risks and losses, and to setting regulatory capital charges. The divergent approaches arise from fundamental differences between the two industries, including the types of primary risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."

My hope is that banking regulators will continue to recognize those fundamental differences as the prudential rules for non-bank SIFIs are being finalized.

Recently, I have seen some encouraging signs. For example, in his February 22 speech on systemic risk, Federal Reserve Board Governor Daniel Tarullo said, "It is important to take the time to evaluate carefully the actual systemic risk associated with [insurance] companies, and to understand the amount of such risk relative to other financial firms before fixing on a list of firms and surcharges."

Similarly, Federal Reserve Board Chairman Ben Bernanke, in his February 27 testimony before Congress, noted that the Fed was considering a Quantitative Impact Study of the effect of bank capital rules on life insurers. To quote Chairman Bernanke: "We are discussing the feasibility of such a study, and we recognize that there are important differences between banks and insurance companies." In my judgment, a quantitative impact study is imperative for the Fed to understand the impact of new capital rules on the market for financial protection products.

A Better Way

The third and final point I want to make today is that there is a better way for the federal government to regulate potentially systemic activities in the life insurance industry.

Let me reiterate what I said earlier: I am not opposed to regulation of the life insurance industry. After all, MetLife is financially liable for insolvencies through the state-based guaranty fund system. What I am opposed to is a regulatory system that creates an unlevel playing field and ultimately harms consumers.

Rather than name a handful of life insurance companies as SIFIs and subject them to an additional layer of federal regulation, a better approach would be to target those activities that caused the financial crisis in the first place. In short, policymakers should adopt an activities-based approach to systemic risk, rather than an institutions-based approach.

A company-specific approach using size as a key criterion runs the risk of overlooking real threats to the financial system. Recall the Long-Term Capital Management debacle of 1998. Although hardly the largest financial firm of its day, LTCM was highly interconnected with the financial system in ways that raised fears of contagion if the firm were allowed to fail. An approach that focuses on activities is more likely to capture systemic risk regardless of the size of the firm.

Dodd-Frank specifically granted regulators the authority to adopt an activities-based approach to systemic risk. Using the data collection powers of the Office of Financial Research, FSOC would monitor the activities of non-banks for systemic risk. FSOC would then use its authority to recommend heightened prudential standards for higher risk activities. That recommendation would be made to the "primary financial regulatory agency" – whether federal or state. In fact, as many of you know, FSOC is currently seeking comment on how it can exercise this authority on the issue of money-market mutual fund reform.

An activities-based approach is also consistent with how regulation of the life insurance business is evolving internationally. For example, the International Association of Insurance Supervisors recently recommended to the Financial Stability Board that only Non-Traditional, Non-Insurance activities – so-called NTNI – should come under heightened prudential standards.

While I'm sure we can debate which activities qualify as NTNI, I hope we can agree that an activities-based approach would eliminate regulatory "gaps" and provide protection against another AIG by subjecting all potentially systemic activities to regulatory scrutiny.

Conclusion

In closing, let me reiterate what I believe are the key considerations for federal policy makers as they attempt to regulate the life insurance industry for the very first time:

The purpose of life insurers is not to avoid risk – it is to accept risk from others, pool it, and manage it so that promised benefits are payable when due.

Aside from Social Security and defined-benefit pensions, the life insurance industry is the only source of guaranteed income that individuals can never outlive. Our role as a provider of income protection should be encouraged, not discouraged.

The traditional life insurance business model does not result in systemic risk to the U.S. economy.

The life insurance industry is highly competitive. Imposing higher capital requirements on only a handful of companies will drive up prices and shift market share to smaller competitors who are not similarly regulated.

The federal government has a legitimate role in overseeing the potential for systemic risk in life insurance companies. The way to manage that risk is with an approach that focuses on activities rather than institutions.

Such an approach would recognize that traditional life insurance companies did not cause the financial crisis.

It would recognize that applying bank-centric capital rules to a few large insurers would result in competitive distortions and harm to consumers.

And it would recognize that preserving robust competition in the life insurance sector is the best way to maximize the availability and affordability of financial protection for consumers.

Thank you very much.

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