RISK & REGULATION

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Risky behavior on the rise among large insurers, NYU professor warns

By Adam Cancryn

Large insurance companies such as MetLife Inc. and Prudential Financial Inc. have ramped up their risky behavior in the years since the financial crisis, a New York University professor warned during a panel discussion at the Brookings Institution.

The insurers took on an increasing percentage of below-investment-grade bonds and shifted more assets to off-balance-sheet vehicles, while escaping scrutiny through "regulatory arbitrage" techniques, C.V. Starr Professor of Economics Viral Acharya said Oct. 14. The result is an industry that has added to its systemic risk during a period where most others are focused on reducing financial hazards.

"Everything in financial plumbing is connected to each other," he said. "We find that the insurance sector really doesn't seem that different from the banking sector."

Acharya's worries stem from a systemic risk system developed at NYU that calculates companies' capital shortfall following a 40% crash in the equity markets over six months. The results showed that MetLife, Prudential and a handful of other big insurers might face an even greater deficit under those conditions today than they would have in the midst of the financial meltdown. By contrast, big banks put through the same stress test appear to perform better now than they would have five years ago.

The rise in the insurers' systemic risk is largely driven by two factors, Acharya said. The first is an increase in the percentage of below-investment-grade RMBS that the industry owned, which jumped to nearly 50% of total RMBS in 2012, from just 6% in 2010. At the same time, companies began to move more assets off their balance sheets and into opaque captive reinsurance vehicles. That made it harder to evaluate the overall risk that insurers carried.

MetLife ceded more than three-quarters of its reinsured life insurance in force to affiliate vehicles in 2013, SNL data show, while Prudential ceded 52.88% of its reinsured business to affiliates.

"There is no risk transfer here," Acharya said. "The A.M. Best ratings, while giving ratings to individual insurance firms, don't take into account these off-balance-sheet liabilities."

He added that insurers' "risk-seeking" activities over the last few years were aided by regulations encouraging the industry to step into areas where banks had pulled back. The NAIC in 2009 approved a rule lowering capital requirements for below-investment-grade RMBS, a change that coincided with the spike in companies' higher-risk, higher-yield investments. States such as Vermont and South Carolina have also joined parts of the Caribbean in making it easier for insurers to set up captive reinsurers.

"I'm stunned by the fact that, just for that particular asset class, there is this capital relief," Acharya said. "This is a sign that at a time when the banking sector is deleveraging, there is an opportunity for someone else who can lever up to make a killing."

Others on the panel pushed back against Acharya's research, arguing that insurance companies' business models are significantly more conservative than banks'. The type of financial crisis needed to take down a large insurer would need to be much more severe than what the U.S. experienced in 2008, NAIC CEO Sen. Ben Nelson said.

"I don't think we expect that to occur," he said. "If there is a tsunami, it certainly wouldn't be limited to the insurance industry."

The NAIC is also working to limit captive reinsurance through principles-based reserving, which he predicted would do a better job of evaluating insurers' risks.

Nevertheless, Acharya promoted the necessity of a federal agency such as the Financial Stability Oversight Council to monitor systemic risk and "harmonize" certain regulations for big banks and insurance companies. Without that coordination, he said, banks and insurers will simply pass risk back and forth, instead of reducing it altogether.

Insurance industry groups and the NAIC have largely opposed federal oversight of insurance companies, maintaining that they are already adequately monitored by state insurance commissioners and pose no broader threat to the global economy.