

Roger W Ferguson, Jr: Globalization, insurers, and regulators: shared challenges call for collaborative solutions

Remarks by Mr Roger W Ferguson, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the National Association of Insurance Commissioners (NAIC) International Insurance Symposium, Washington DC, 23 February 2006.

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I am honored to deliver the keynote address at this important international symposium. Our focus today--on how developments and challenges around the world are reshaping the insurance industry and its regulation in Europe, Latin America, China, and India as well as here in the United States--is certainly warranted. The worldwide integration of economies and financial markets is increasing, and a sound and vibrant insurance and reinsurance industry is needed to sustain global economic growth. Thus, I am glad to see that this symposium has brought together regulators and major market participants from all parts of the globe.

Within the United States, the National Association of Insurance Commissioners (NAIC) has over the years promoted interstate collaboration on regulatory matters, established and maintained a centralized information system, and supported and improved the state regulation of insurance. Through its work, the NAIC has enhanced the reliability and financial health of the domestic insurance industry.

The NAIC has also been active in fostering cooperation on supervisory issues in the international insurance arena, through groups such as the International Association of Insurance Supervisors (IAIS), which the NAIC currently chairs; the International Accounting Standards Board (IASB); and the Joint Forum. The NAIC is, of course, also actively involved, through the IAIS, in the work of the Financial Stability Forum (FSF), of which Alessandro Ippa is a member. The work of the FSF is the main topic I will speak about today. Before I proceed, I want to say that the views I will express are not necessarily shared by my colleagues on the Board of Governors.

The FSF has taken an interest in a variety of developments affecting the financial sector in recent years. I would like to leave you with three messages based on its work in this area: first, effective collaboration among regulators and other authorities is important; second, enhanced transparency and disclosure are important; third, firms and regulators need to have early and continuous dialogue on regulatory developments.

I will discuss these statements in a minute, but before turning to them I want to give you some background on the creation of the Financial Stability Forum, its composition, and its purpose. As you may know, the FSF was established in 1999, in the wake of the Asian financial crisis, to promote international financial stability. The FSF uniquely brings together national authorities responsible for financial stability in major international financial centers, representatives from international financial institutions, representatives of international regulatory committees, and committees of central bank experts. Its role is to foster cooperation among authorities at a global level in identifying vulnerabilities and strains in the global financial system and developing strategies to reduce systemic risk.

An important element of the FSF's work is to assess risks to financial stability that might arise from current economic and financial developments, to discuss risk scenarios, and to consider the capacity of the financial sector to absorb shocks. Several years of solid economic growth and a benign financial environment have helped strengthen balance sheets in the financial sector, and this strength seems likely to continue. Nonetheless, a number of risks and potential vulnerabilities are receiving attention, including the implications for growth and inflation of high oil prices; global fiscal and current account imbalances; elevated house prices and household debt; the compression of risk spreads, which has contributed to low long-term yields; and the potential financial fallout from geopolitical events.

I am sure that you yourselves are closely evaluating what these and other matters imply for the insurance industry. Consider, for example, the effect of low long-term interest rates on the insurance sector. Low interest rates may have induced some firms to take on extra exposure through investment in higher-risk assets, including complex or less highly-rated credit products. In some cases, mainly outside the United States, insurers have had difficulty earning sufficient returns to meet the minimum rate they have committed to pay to policyholders. Generally, however, the industry seems to be increasingly focused on better matching the risk characteristics and duration of assets and liabilities. In

fact, this better match may be one factor supporting low yields on longer-dated fixed-income assets, at least in some markets.

But there are other potential explanations for the low long-term rates now prevailing in many countries. These other explanations include an excess of desired global saving over desired global investment spending and a decline in the risk premia demanded by investors, with the latter likely due in part to a marked decline in the volatility of economic activity and inflation. Suffice it to say, we do not have a full understanding of the complex forces that have driven rates down, and the topic is likely to be debated for some time to come. Some observers have expressed concern about the possibility of a steep rise in long-term rates from their currently low levels. Were such a move to occur, the implications for the economy and asset prices would depend on the source of the rate increase. If, for example, desired investment spending were to strengthen--thereby boosting economic growth--the induced rise in longer-term rates need not be a worrisome development. On the other hand, a sharp increase in risk premia, whether because of a rise in perceived risk or a reduced willingness to bear risk, likely would be more problematic. We simply cannot know before the fact whether a potential rise in longer-term interest rates would be disruptive or not.

In addition to their exposure from unexpected developments in financial markets, insurers face a variety of other significant risks, including the potential liability arising from acts of terrorism and natural disasters. At present there is also much speculation about the likelihood and the possible effects of an Avian flu pandemic. The possibility of a pandemic gives rise to new issues for insurance and reinsurance companies. Pandemics may result in significant losses for parts of the insurance sector from increased sickness and mortality. At the same time, a pandemic could pose operational challenges by causing widespread and extended absenteeism and by disrupting the usual flow of goods and services throughout the world economy. All firms, including insurers, would probably be wise to give serious thought to the question of how they would run their business in the event of an Avian flu pandemic.

Given that the industry faces these and other risks, the three messages I mentioned earlier take on special significance. I would now like to expound on each of them.

Effective collaboration among financial authorities

Globalization is creating new business opportunities, opening new markets, increasing efficiency, decreasing the cost of capital, and enabling well-managed companies to deliver expanded services and greater shareholder value. However, these forces are also prompting financial companies to develop far-flung business operations, which make group management and risk aggregation more challenging. At the same time, these forces are blurring business and sectoral lines and making exposures more interrelated. Such challenges to management exist even in a totally domestic setting, but globalization has increased their difficulty and complexity and has intensified the need for supervisory collaboration, especially between home and host supervisors, within and across sectors.

In the United States, the nationwide reach of the largest insurers has led to an increasing emphasis on interstate cooperation among insurance supervisors through the NAIC. Now the development of financial conglomerates has rightly prompted increased links with supervisors in other sectors. Meanwhile, globalization has necessitated intensified supervisory cooperation at the international level. In this respect, I am encouraged to see that the NAIC has been meeting twice a year with the European Union since 1999 to address issues affecting transatlantic insurance business. These meetings have led to a Memorandum of Understanding on information exchange and to discussions about the supervision of reinsurance. Similar arrangements for information exchange have also been established with insurance regulators in China, India, Japan, Latin America, and Russia.

I should also like to commend the IAIS for its work over the years in promoting international insurance standards and information exchange. The FSF greatly welcomes the continuing work by the IAIS on encouraging practical cooperation among supervisory authorities and on examining whether there are significant barriers to the exchange of information relating to groups and conglomerates.

Regulators must sustain work in this direction as insurance activity continues to expand internationally, resulting in large, internationally active insurance groups. Because of the formation and activity of such large groups, regulators must have a good picture of the totality of risks that each insurance or reinsurance group is running. Regulators need to confer and to compare national systems so as to identify regulatory best-practices and avoid duplicative regulatory work. It is important also for each regulator to understand and evaluate the major changes in the laws and regulations in the other

regulators' countries and the international implications of the changes. Developing strong working relationships through regular, ongoing dialogue also creates better channels for communication when difficulties arise.

For cross-sectoral international issues, the NAIC makes a valuable contribution to the work of the Joint Forum, which as you know is a group that brings together banking, securities, and insurance regulators from many countries to evaluate and address cross-sectoral regulatory issues. Some key areas of the Joint Forum's work in which the FSF has taken a close interest are the review of the regulatory and market differences across sectors; credit risk transfer; high-level principles regarding outsourcing and business continuity; and the funding of liquidity risk. Many of these issues have the potential to affect financial stability and are of interest not only to the supervisors but to our central bank and finance ministry members.

Enhanced transparency and disclosure

Transparency and public disclosure are essential for the efficient functioning of markets. Counterparties and investors need to be clear about the risks that firms and the industry are taking in order to manage their own exposures.

The FSF takes an active interest in this area. Its interest is not just to the narrow question of determining which data items to disclose but in the whole process of information disclosure. The FSF is promoting the development of high standards for accounting and auditing, the establishment of public-interest bodies to oversee the standardsetters' work, and the development and adoption of best-practice disclosure.

Let me elaborate a little on the FSF's interest in the transparency and disclosure practices of the reinsurance sector. After the events of September 11, 2001, and the significant downturn in global equity markets in 2001-02, questions arose whether reinsurance capital might erode to the point that primary insurance capacity would deteriorate. Also at that time anecdotal reports of the industry's growing involvement in credit risk transfer activities, both as investors and as sellers of credit protection, led to concern that such involvement increased the risk that reinsurance difficulties could have wider implications in the financial system. The FSF found that the absence of adequate information at the time made it difficult to assess the knock-on effects of potential difficulties in the sector on primary insurance and on other areas of the financial system.

As a result, the FSF encouraged and supported efforts by the IAIS and its working groups (Task Force Re and the Reinsurance Transparency Group) to shed light on these issues. The first and second Global Reinsurance Market reports have since been released and have been well received by FSF members and other users of information. Despite limitations arising, in part, from different accounting conventions, the reports provide analysis that enables stakeholders to gain deeper insight into the structure and profile of the reinsurance industry and its links with other sectors of the wider financial system.

Forum members have expressed an ongoing interest in further information on the reinsurance industry's systemic links. In this regard, I would also like to welcome the recent work by the G30 on the reinsurance sector and international financial markets. Contained in the G30 report is a chapter on transparency that sets out a framework to improve the disclosure of risk information by reinsurers. With financial markets and product offerings constantly evolving, firms and the industry must release timely, comprehensive, and meaningful information to enable counterparties, investors, and regulators to do their evaluation and analysis.

Early and continuous dialogue about regulatory developments

One area that is now receiving attention in both the private and the official communities is the perception that the financial industry is suffering from regulatory overload. This perception arises partly because of a bunching of regulatory initiatives in recent years. But concern about a more continuous accumulation of regulation over time has also arisen.

Of course, regulations that improve the strength and integrity of the financial system justify an element of regulatory burden. At the same time, the costs and benefits of new regulations need to be carefully weighed against each other, taking full account of financial industry input. Industry commentary has already resulted in significant and beneficial changes to regulations and directives. I encourage firms

to continue engaging actively and early with regulatory authorities on the range of international regulatory and legislative developments to ensure that the authorities have the full benefit of your expertise as they set policy.

All these changes mean challenging times for both industry participants and regulators. Companies must keep up with changing regulations and reporting requirements and must allocate part of their limited time and resources to dealing with them. Regulatory resources are stretched as well, and I understand many regulators are working hard to ensure that the intensity of regulatory implementation efforts does not divert resources from ongoing supervision. Regulators and industry participants will have to work together to meet these challenges.

We must recognize, however, that regulatory initiatives also reflect a more complex environment. Governments and the public at large understandably want to ensure that safety and soundness are maintained despite complexity. The intricate challenge here is to find the right balance between regulation, on the one hand, and the fostering of industry-led solutions through improved risk management and market practices, on the other.

I should like to say that the FSF fully supports the role of the IAIS as the global standard setter for the insurance and reinsurance industry. We also commend the IAIS on the good work it has been doing in developing principles, standards, and guidance on insurance and reinsurance supervision and in promoting their implementation. This work contributes significantly to improved supervision of the insurance industry, to the development of well-regulated insurance markets, and to global financial stability.

The NAIC has been active in monitoring discussions and reviewing and commenting on insurance regulatory and supervisory papers. I have no doubt that, given the importance of the coming initiatives, the NAIC will continue to do so.

Conclusion

Ladies and gentlemen, it has been my pleasure to set out some thoughts about several issues you will debate at this symposium. I think that you will agree with me on the need for effective supervisory collaboration, for enhanced transparency, for public disclosure, and for a dialogue with industry participants to ensure a well-designed regulatory regime that is effective and proportionate to the risks it addresses.

The good news is that, in the future, growing global markets will present new and potentially rewarding opportunities for insurance companies. Perhaps the not-so-good news is that the industry is also likely to face a multitude of challenges. The industry has made much progress in recent years. Insurers and reinsurers have revised their underwriting philosophies, developed new models to assess risk, improved the adequacy of their risk profiles, and adjusted their coverage policies. Many regulators have also made significant changes to ensure that their regulations keep pace with developments or, at least, do not fall too far behind. These efforts give me confidence that both firms and regulators will continue to meet the challenges that lie ahead.

Thank you, and I wish you all a very fruitful symposium.