Masaaki Shirakawa: Insurance companies and the financial system – a central bank perspective

Keynote address by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the 18th Annual Conference of the International Association of Insurance Supervisors (IAIS), Seoul, 30 September 2011.

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I. Introduction

It is a great privilege to have the opportunity to speak here today. Before starting, I would like to express my deep respect for the countless contributions made by the International Association of Insurance Supervisors (IAIS) since its establishment in 1994.

The Bank of Japan has consistently had a keen interest in developments in the insurance business, although it does not have the authority to supervise insurance companies in Japan. As you know, Japan experienced a financial crisis from the late 1990s through to the beginning of the 2000s, during which a few small and medium-sized insurance companies failed. In a country with a significant insurance sector, these failures were one of the factors that had a considerable impact on the macroeconomy. The causal relationship between insurance companies and the macroeconomy also holds true the other way around. Macroeconomic developments can have a significant effect on the financial system, including insurance companies. In fact, Japanese insurance business from the late 1990s onward cannot be discussed without reference to Japan's declining population and the "negative spread problem" caused by continued low interest rates. I hope this gives you some background on why the Bank of Japan has such a strong interest in insurance business.

The title of my speech today is "Insurance Companies and the Financial System: A Central Bank Perspective." First, I will talk about the significance of a shared aspect of the remit of insurance companies and central banks: providing stability and security. Next, I will discuss the current state of the global economy, with particular reference to its effects on the business of insurance companies. Finally, I will offer my thoughts on regulation and supervision of insurance companies.

II. Provision of stability and security

Looking at the relationship between central banks and insurance companies, the two have in common their role as providers of stability and security. From the moment human beings began to engage in organized economic activity of some sort, there was a prevailing sense of awareness of the need to transfer risks that could not be borne by an individual economic entity to other economic entities and to diversify them. The Code of Hammurabi, a Babylonian law code dating back to around the 18th century B.C., apparently refers to a contract under which the owner of a trading vessel who, when applying for loans for procuring cargo, paid a special fee in advance and was thus exempted from repayment of the relevant loans in the case of loss or damage of the cargo procured. This early example of an insurance contract shows how important it is for an economy's development to transfer and allocate risks that exceed the risk-taking capacity and appetite of individual economic entities.

Compared to the history of the insurance business, central banking is a relatively new invention. Although the oldest central bank has a history of nearly 400 years, the central bank in a modern sense only appeared in the mid-19th century. As economies became more complex and networks of banks started to provide credit for economic activity in an organized manner, there was an increasing need for someone to play the role of ensuring the stability of the network, or in other words the financial system. The financial system is built on mutual

trust among participating financial institutions. Once such confidence is undermined and participants become beset with doubts and fears, the financial system destroys itself in a self-fulfilling manner. In order to stop such a vicious cycle before it ended in catastrophe and to ensure the stability and security of the financial system, central banks started to function as the "lender of last resort."

Central banks also provide stability and security in another form. Under the gold standard, which was adopted until the 1930s, at least theoretically the outstanding amount of gold held by individual countries formed the basis of the value of their currency and economic activity. After the gold standard was abandoned, it became necessary to conduct active policy intervention, with central banks playing part of this role. Through the conduct of monetary policy, central banks began to work toward fostering an environment in which individual economic entities were not disturbed by macroeconomic uncertainties such as large fluctuations in prices.

To sum up, both insurance companies and central banks provide economic entities with stability and security through their respective business. Such contribution facilitates risk-taking by economic entities and, consequently, promotes economic growth.

By the way, in addition to having the similarity of both working to achieve stability and security, insurance companies and central banks share some of the same difficulties. Insulation from significant risks that cannot be borne by individual economic entities will stimulate economic activity but it could also encourage excessive risk-taking. Taking the example of car insurance, drivers insulated from liability for compensation could drive at excessive speed and cause accidents. This, as you know, is a textbook example of the "moral hazard" problem.

Central banks also face the problem of moral hazard. Instead of contributing to financial system stability, the "lender of last resort" function of central banks could end up threatening that very stability by encouraging excessive risk-taking by banks. Also, in terms of macroeconomic stability, it is sometimes pointed out that the recent financial crisis was partly attributable to what is sometimes referred to as the "Great Moderation" from the 1990s to the mid-2000s, a period characterized by a favorable combination of low inflation and high growth, and a time of too much confidence in central bank policy, which contributed significantly to the moderation. As moral hazard is one of the most important topics of discussion for monetary policy, financial system stability, and regulation and supervision, I will return to it toward the end of my speech.

III. Current state of the global economy and financial markets

Next, I would like to turn to the current state of the global economy, with particular reference to its effects on the business of insurance companies.

Developments in the global economy following the failure of Lehman Brothers

It is now three years since Lehman Brothers collapsed in September 2008, triggering the financial crisis. Developments in the global economy thereafter can be summarized into the following three points.

First is the fact that the global economy has managed to prevent a depression that might well have been as severe as the one witnessed in the 1930s. This significant achievement can be attributed to the effective measures to stabilize the financial system and to the bold monetary and fiscal policy after the failure of Lehman Brothers.

Second, the global economic recovery has been bifurcated so far. Emerging economies started recovering relatively soon after the crisis and have continued to post high growth. In contrast, given the significant downturns of advanced economies after the failure of Lehman Brothers, their pace of recovery thereafter has been slow.

Third, the downward pressure exerted on advanced economies by the repair of balance sheets is a root cause of their sluggish recovery. The global credit bubble in the mid-2000s was incredibly large. When such a huge bubble bursts, balance sheets have to be repaired, or in other words, excesses in stock and corresponding debt have to be adjusted. Furthermore, economic activity is restrained for the duration of that process. The sectors requiring balance-sheet adjustment differ according to the country: in the United States, it has been needed in the household and government sectors; in Europe, the financial and government sectors. The recent fiscal deterioration is attributable to several developments. One is the aggressive measures implemented by governments and a decline in tax revenue associated with economic deterioration after the onset of the financial crisis. The other, which applies to some countries in the euro area, is the weakening of fiscal discipline amid favorable issuing conditions of government bonds brought about by the introduction of a common currency. In any case, the time required to complete the repair of balance sheets largely depends on the magnitude of the bubble and financial imbalances preceding the adjustments.

To sum up, although we have managed to prevent another great depression, conditions are not exactly favorable for the global economy as a whole. This reflects the prolonged balance-sheet repair taking place particularly in advanced economies, which is counteracting the growth momentum being maintained in emerging economies. A particular point to note in this regard is that, in advanced economies, deteriorations in fiscal balances, combined with historically low interest rates, are recognized as restraints on the implementation of additional policy stimuli, and this is further undermining the already fragile recovery process.

Current state of global financial markets

Amid the developments in the global economy that I have mentioned, we have observed various changes in global financial markets.

First, long-term interest rates of advanced economies have reached historically low levels and the yield curve is generally flattening. Underlying this are increased market expectations that major central banks of advanced countries will continue with accommodative monetary policy given the increasingly cautious views about the economic outlook.

Second, investors are becoming increasingly risk-averse. Especially after this summer, stock prices fell and credit spreads widened on corporate bonds as investors became more risk averse and entered what is often called “risk off” mode. In government bond markets, U.S. and German interest rates declined partly due to market participants’ preference for risk-free assets, while interest rates in peripheral euro-zone economies rose substantially. In foreign exchange markets, the Swiss franc and the Japanese yen appreciated as they were viewed as relatively safe-haven currencies.

And third, there is rising concern about sovereign debt. As I have described, fiscal balances in many advanced economies deteriorated after the failure of Lehman Brothers. In Europe, Greece, Ireland, and Portugal successively had to receive financial support packages. The sovereign spreads of peripheral euro-zone countries have remained wide, reflecting heightening market concerns about sovereign debt.

Implications for insurance companies

The current state of the global economy and financial markets definitely has significant implications for the insurance business.

First of all, with little room left for fiscal stimulus, central banks in advanced economies have strengthened so-called unconventional monetary policy. While those central banks, including the Bank of Japan, have tried a variety of unconventional monetary policies, one common feature is that a flattening of the yield curve has been observed in the process. If the repair of balance sheets takes a certain length of time, the flattening could also last for that period. For

some insurance products that cover a long time period, a slight difference in a discount rate could result in a significant variation in asset value. Therefore, the management of insurance companies as well as the regulatory and supervisory authorities need to consider carefully whether the current low interest rate environment is an exceptional case or not.

Next, increasing risk arising from sovereign debt could call for a review of the risk management practices that have been adopted by insurance companies. Insurance companies have made efforts to match the durations of their insurance payment liabilities and the products in which they invest their insurance premiums. They have invested in super long-term government bonds to address mismatch risk arising from long-term contracts such as life insurance. If the credit risk associated with sovereign debt is not negligible, these risk management practices will become less effective.

Finally, with their long investment horizons, insurance companies are expected to take advantage of market distortions caused by risk aversion among investors with shorter horizons. If insurance companies are currently having difficulties doing this, we need to consider the background to the situation and what the authorities can do to address the issue.

At this juncture, central banks in advanced economies, including the Bank of Japan, are deploying strong monetary easing measures to ensure the global economic recovery. Given that we are already in the uncharted territory of unconventional monetary policy, it is important to weigh the benefit of such policy against its cost by carefully considering the following matters: whether a given policy is having its intended effect; whether it is causing an unexpected distortion in financial markets; and whether there are any other policy options for achieving the same results.

IV. Regulation and supervision of insurance companies

Financial system stability

Until now I have been describing the current state of the global economy. Now I would like to turn to my last topic for today: regulation and supervision of insurance companies. We can point out two reasons to regulate and supervise financial institutions including insurance companies: consumer protection and prevention of systemic risk. With regard to the latter, whether insurance companies could cause systemic risk has been frequently discussed. One camp argues that, compared to banks, insurance companies themselves are less likely to become the epicenter of a liquidity crisis or to cause systemic risk because their liabilities are mainly long-term ones based on insurance contracts. Although such an argument is valid in a comparative sense, the global financial crisis shows that we cannot safely say that the failure of insurance companies would not cause systemic risk. As financial markets become increasingly interconnected, we cannot deny the possibility that a deterioration in the business conditions of insurance companies, or their failure, could trigger cancellations of savings insurance products or a deterioration of market sentiment that would undermine the stability of the financial system as a whole. When insurance companies are also involved in a wide range of business operations through their subsidiaries, such operations could trigger systemic risk. During the financial crisis, the U.S. Federal Reserve provided a large amount of funds to AIG, based on the judgment that such risk was highly significant. When small and medium-sized insurance companies failed in Japan, the Insurance Policy-Holders Protection Corporation was established and the Bank of Japan established a temporary credit line to the corporation, although it was never activated.

Designing regulatory and supervisory frameworks: finding the right balance

Various international efforts have been made in the areas of regulation and supervision of financial institutions, including insurance companies, with the aim of preventing future financial crises. With regard to bank regulation, the introduction of the Basel III framework

was internationally agreed in 2010. This summer, planned measures were announced for global systemically important financial institutions, or G-SIFIs, including an additional capital charge and the establishment of a smooth resolution framework for winding down such institutions. In parallel with such developments, active discussions have been taking place to change the regulations for insurance companies, including the Solvency II Directive in Europe.

As financial transactions become more complex and globalized, reforming our frameworks for financial regulation and supervision is becoming an extremely challenging task. Although it is easy to point out problems with any reform proposals, it does not mean that current frameworks should remain unchanged. In order to prevent financial crises, the regulatory and supervisory authorities, central banks, and financial institutions need to do their utmost to successfully make the necessary reforms. Today I am not going to discuss specific reform measures given the time constraints. Instead, as a guiding principle for reforming the frameworks for international financial regulation and supervision, I would like to emphasize the importance of finding the right balance in various respects without relying too much on any specific methodology. This is based on the recognition that our knowledge is still quite limited with respect to the intrinsically complex mechanisms of the financial system, which continue to evolve in a dynamic manner. The need for humility is obvious when we look back on how bubbles have developed and burst in the past and how financial crises have followed thereafter.

In terms of finding the right balance, it is first of all important to strike a balance between regulation and supervision on the one hand and the macroeconomy on the other. While regulation and supervision is, of course, important, the macroeconomic environment is also critical. Our experience of financial crises clearly shows that various risks can accumulate in a seemingly benign macroeconomic environment and the materialization of those risks in the form of a financial crisis could end up causing significant economic damage. This is the sort of moral hazard that I spoke of earlier in which perceptions that risks have declined invite excessive risk-taking. In this sense, when conducting monetary policy we need to pay due attention not only to price developments but also to the accumulation of financial imbalances such as asset price inflation, leveraging and increasing maturity mismatch.

Second, the balance between regulation and supervision is important. Business models of financial institutions differ by country and institution. Against the backdrop of financial globalization and advances in information and communication technology, individual financial institutions need to flexibly adjust to changing business environments. Given this, enforcing "one-size-fits-all" regulations for various types of financial institutions could increase the likelihood of adverse side-effects. In order to avoid this, we should rely more on supervision than we do today. We must design a comprehensive framework that better combines regulation and supervision.

Third, it is crucial to find the right balance by paying due attention to similarities and differences in the functions of various financial institutions. Insurance companies are important providers of long-term funds to banks and other sectors. They can play this role because their liabilities are mainly long-term. This makes them less vulnerable to interest risk arising from maturity transformation and liquidity risk in comparison to banks. On the other hand, insurance companies have inherent insurance risk on their liabilities. As such, insurance companies and other financial institutions including banks have different functions and risk profiles. Collectively and in complement to one another, these various types of financial institutions perform important financial intermediation functions in the economy. There is also a similarity. In the current global financial markets, various types of financial institutions perform socially beneficial financial functions using their various distinct products. For example, options, one type of derivative instrument, are very similar to insurance. Of course, we should not denounce overlaps between different financial products that provide the same economic function. If more competition lowers the cost of financial services, it could benefit society as a whole. However, significant risk could be created depending on the

incentive structures in the overlapping areas. In that sense, due attention should be paid to both similarities and differences in the functions of insurance companies and other financial institutions.

I know that the points I have made so far are typical examples of something being easier said than done. Still, I believe these points are absolutely critical and should be considered when designing regulatory and supervisory frameworks.

V. Concluding remarks

As I have already used up most of my time, I would now like to conclude my remarks. With some exceptions such as France, the Netherlands and Belgium, in many advanced countries a central bank is not directly in charge of the regulation and supervision of insurance companies. Nevertheless, central banks have a keen interest in the activities of insurance companies, as insurance companies are an important player in the financial system. It is important that central banks take part in the discussion about the design of regulatory and supervisory frameworks for insurance companies. Another potentially significant contribution by central banks is to analyze potential risks within the financial system as a whole, including insurance companies, and present the results to the public. This is what we call macro-prudential analysis, an area that is increasingly seen as important in recent years. In Japan's earlier financial crisis, its insurance sector was hampered by the "negative spread problem" and capital losses on equity holdings. Insurance companies' business conditions are affected less by short-term economic and financial fluctuations and more by long-term developments. Put another way, as insurance companies have the unique characteristic of handling long-term funds, it is particularly important for them to manage risk from a long-term perspective with emphasis on the interaction between the real economy and the financial system. When we think about coming developments in the global economy and their impact on insurance business, there are many factors that underscore the importance of macro-prudence, including the likelihood of continued low interest rates, sovereign debt problems, and demographic changes. In that sense, let me close my remarks by stressing the importance of cooperation and exchanges of views among insurance companies, regulatory and supervisory authorities, and central banks. Thank you very much.