



Systemic Risk Defined

"Systemic risk" refers to the likelihood and degree of negative consequences to the larger body.

With respect to federal financial regulation, the systemic risk of a financial institution is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects.

How to Measure Systemic Risk

Too Big to Fail: The traditional analysis for assessing the risk of required government intervention is the "Too Big to Fail" Test (TBTF). TBTF can be measured in terms of an institution's size relative to the national and international marketplace, market share concentration (using the Herfindahl-Hirschman Index for example), and competitive barriers to entry or how easily a product can be substituted. While there are large companies in most financial marketplace segments, the national insurance marketplace is spread among thousands of companies, and the barriers to entry in a business where capital is the primary input are relatively minor. The policies of one homeowners' insurer can be relatively easily substituted for another or picked up by a state residual market provider, with limits on the underwriting fluidity primarily stemming from state-by-state regulatory impediments, such as limits on pricing and capital mobility. There are arguably either no or extremely few insurers that are TBTF in the U.S. marketplace.

Too Interconnected to Fail: A more useful systemic risk measure than a traditional TBTF test is a "Too Interconnected to Fail" (TICTF) assessment. An intuitive TICTF analysis has been at the heart of most recent federal financial emergency relief decisions. TICTF is a measure of the likelihood and amount of medium-term net negative impact to the larger economy of an institution's failure to be able to conduct its ongoing business. The impact is measured not just on the institution's products and activities, but also the economic multiplier of all other commercial activities dependent specifically on that institution. It is also dependent on how correlated an institution's business is with other systemic risks.

Property/casualty (P/C) insurance companies, other than in a few specialized segments noted below, present relatively low systemic risk because they generate relatively little counterparty risk and their liabilities are generally independent of economic cycles or other potential systemic failures. With respect to liabilities, P/C products tend to be mandatory with inelastic demand, so revenues are less affected by other systemic risks. Recessions or 3rd party failures do not significantly increase workers' injuries, auto accidents, or house fires. Insurance contracts are not typically subject to further hedging or risk arbitrage (unlike mortgage underwriting or financial guarantees that may be subjected to numerous cycles of securitization and further third party financial guarantees or risk betting). While some portions of primary risks are passed on to reinsurers, the risks are not further multiplied or leveraged, and the primary company almost always remains obliged on and retains a portion of the underlying risk. With respect to assets, p/c insurers don't hold other people's money, so there is no vulnerability to a "run on the bank," and they only underwrite based on their own assets (unlike depository institutions, investment funds, or retirement accounts) with less leveraging statutorily allowed than for other insurance or financial companies. Ultimately, while the economy is highly dependent on the p/c industry, the industry's risks are independent and relatively walled off from other systemic impairments.

Examples: Even a very large auto insurer poses very little systemic risk to the larger economy. Few commercial third parties rely on a specific auto insurer's policies that would suffer immediate

economic losses or decline, other than the insurer's direct investors. Policyholders would be largely protected by existing state guaranty funds, third party accident claimants would be similarly protected through such funds (as well as under their uninsured motorist coverage), and new business could be switched relatively easily to other providers or a state residual market provider. The insurer's contracts with its agents and other suppliers would migrate quickly to new underwriters, and the beneficiaries of its investments would similarly migrate over a relatively short period of time. The insurer's failure would be relatively independent from a larger economic cycle or downturn – its investment portfolio is required to be relatively conservative and unleveraged, and its auto losses would be relatively uncorrelated with any economic cycles or systemic risk waves. Unlike banks and securities firms, a property-casualty insurer failure would not cause a run on the industry since the products are essentially mandatory and overall demand is relatively inelastic. While the failure of a large auto insurer would be undesirable, and perhaps even cause a short period of transitory disruption in a local auto insurance marketplace, the negative economic consequences to the larger economy would be relatively limited – primarily transition costs and any net losses of the specific company.

Exceptions: A small number of p/c insurance market segments present a different systemic risk vulnerability. For example, the credit downgrading of a small number of bond insurers (and unregulated investment companies offering equivalent financial guarantee products) last year played a role in the trillions of dollars of third party credit default swaps that are still being unwound. That deleveraging process has triggered a domino affect of other negative economic consequences throughout the globe, including freezing numerous capital markets that have limited general consumer and commercial financing. A few very large state owned/run insurance funds may also present slightly higher systemic risk, particularly for natural catastrophe exposure, since they tend to be severely underpriced, underfunded, and most likely to require additional capital after events that would cause competing state budgetary impairments and needs. Mortgage insurance is more correlated with economic cycles and susceptible to further 3rd party leveraging, although the companies are still subject to strict leveraging and investment limits, rely on their own capital, and sell a product that is essentially mandatory and thus less elastic in demand. Surety insurance can also be susceptible to economic cycles, although it has not presented a systemic risk in the current economic cycle. Reinsurance has a slightly different risk profile than primary insurance, but is similarly uncorrelated to other systemic risks and the negative effects of reinsurance failures are mostly confined to the insurance industry.

AIG

It should be noted that AIG was not "Too Big to Fail", but ultimately received unusual federal assistance because it was "Too Interconnected to Fail". AIG's *insurance* units were mostly engaged in underwriting coverages that other insurers would be able to assume over a relatively short period of time. Almost all of AIG's subsidiaries have continued to successfully operate except for AIGFP, an *unregulated* entity engaged in financial guarantees and derivatives activities. AIGFP, however, was involved in hundreds of billions of dollars of risk swaps that were relied upon and further highly leveraged by numerous 2nd and 3rd parties. The credit downgrading of AIG because of the liabilities of AIGFP, and its inability to raise sufficient additional offsetting capital, set off a series of 2nd and 3rd party adjustments that continued to ripple through the economy with deleterious consequences until the federal government stepped in with an additional backstop. This made AIGFP, and thus the AIG thrift holding company as a whole, TICTF. While AIG's insurance operations are large, they did not generate the same level of systemic risk. The economy, after a short period of market transition, would be better able to adjust to a severe impairment of AIG's insurance subsidiaries than its non-insurance operations. AIG did suffer write downs from its securities lending business, which involved borrowed assets from its life (but not property-casualty) insurance subsidiaries, but these losses were much less in scope than the AIGFP exposure.

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