Minutes of the November 10, 2017 Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, Bradford Hu, Robin Greenwood, Charles Himmelberg, Ralph Koijen, Deborah Lucas, Lynn Paquette, Stephen Ryan, Tano Santos, Til Schuermann.

FRBNY: Adam Ashcraft, Nina Boyarchenko, Nicola Cetorelli, Gerard Dages, Dianne Dobbeck, William Dudley, Linda Goldberg, Michael Held, Beverly Hirtle, Lorie Logan, Megan McConnell, Simon Potter, Kevin Stiroh, James Vickery.

Non-bank financial intermediation and systemic risk was the main topic of the Financial Advisory Roundtable (FAR) meeting. The meeting included two prepared presentations from roundtable members, the first on the insurance industry (focusing primarily on life insurance), and the second on asset management. These presentations were followed by an open discussion on the topics listed in the meeting agenda.

The Insurance Industry and Systemic Risk

FAR members discussed how life insurers' risk exposures have evolved over time. Traditionally, life insurance firms have been exposed to longevity and health risks as well as interest rate risk. More recently, however, life insurers have become increasingly exposed to aggregate market risk through the issuance of variable annuities (VA) with minimum return guarantees, generally in the form of a guaranteed lifetime withdrawal benefit. This market risk is difficult to manage, given the long maturity of VA products, although derivatives are sometimes used to partially hedge these risks. FAR members noted that VA exposures create significant downside risk for life insurers if long-term equity returns are low and interest rates remain low. Several FAR members felt that capital requirements for insurers offering guaranteed VA products are too low, given the uncertainty about long term asset returns. It was noted, however, that fees on guaranteed variable annuities have increased since the 2008 financial crisis, and the number of insurers offering guaranteed products has fallen.

FAR members also discussed the growth in "captive" reinsurance. Reinsurance allows operating companies (i.e., life insurers selling directly to consumers) to significantly reduce the statutory reserves they are required to hold for life insurance policies written. Increasingly, insurers are reinsuring risk through captive reinsurers that are affiliates of the operating companies. Captive reinsurers are concentrated in a small number of states, reflecting state-by-state variation in insurance regulation.

Participants expressed concerns that captive reinsurance represents a form of regulatory arbitrage which does not significantly reduce insurers' overall risk exposure, particularly given that the obligations of captives are often guaranteed by the parent. FAR members also argued that captives are opaque; they are often unrated and provide less information about their activities and capitalization than do operating companies. Data available for captive reinsurers in one state shows that captives' surplus would be substantially lower under statutory accounting compared to their reported values based on state-based rules. FAR members argued that greater transparency would make it easier to assess the risks posed by captive reinsurance and encourage better risk management practices. This could be achieved by more detailed financial reporting and harmonizing reporting requirements across states.

FAR members also discussed connections between insurance and other parts of the financial system (e.g., captive reinsurers often have letters of credit from banks), and considered the overall level of systemic risk posed by the insurance sector. Participants noted that appropriately measuring risks for life insurers is particularly challenging given the long maturities of their liabilities and assets and the fact that they are buy-and-hold investors. FAR members noted, however, that because life insurers have fewer short-term liabilities than banks, a crisis in the insurance industry would play out more slowly than a banking crisis, and may be less likely to involve widespread runs by liability holders. The nature of insurers' risks, however, increases their exposure to long-run shifts in the economy, such as changes in demographics or secular shifts in the level of interest rates.

Asset Management and Systemic Risk

FAR members discussed whether the asset management (AM) industry poses significant systemic risk. Meeting participants also considered whether monitoring and regulation of systemic risk in asset management should follow an "entity-based" approach, an "activity-based" approach, or some combination of the two. An entity-based approach focuses on identifying systemically important institutions whose failure or financial distress would cause significant dislocation in the financial system as a whole. An activity-based approach instead focuses on financial products and activities, rather than individual entities. Although several nonbank institutions were designated as being systemically important by the Financial System Oversight Committee (FSOC) in the wake of the 2007-09 financial crisis, no asset management firms were designated, and the Treasury has more recently indicated support for an activity-based approach to AM regulation.

A common argument for why asset managers do not pose systemic risk as individual entities is that the manager acts as an agent, not as a principal: managers do not own the fund's assets and their balance sheets are separate from those of the fund. Some FAR members, however, noted cases where asset managers do act as principals (e.g., in securities lending), and noted other interconnections between the fund manager and the assets under management (e.g., fund flows are responsive to regulatory investigations or other scandals affecting the asset manager).

In the context of this discussion, FAR members considered whether open-ended mutual funds pose significant systemic risk. Open-ended funds are subject to large investor redemptions during stress events, and are thereby subject to run risks analogous to banks. During a crisis, redemptions may cause asset fire sales, leading to sharp reductions in asset prices particularly for less liquid assets. FAR participants discussed evidence that these movements in asset prices can be persistent rather than short-lived. Analysis discussed at the meeting suggests that fire sale vulnerabilities in AM have increased significantly since 2009, driven both by an increase in assets under management and increasing flow-return sensitivities. Estimated fire sale spillovers to banks increased between 2009 and 2012, although they have declined more recently.

Other FAR members argued that many asset managers such as mutual funds make limited use of leverage, and questioned whether the AM sector generated additional risk of asset fire sales relative to the holding of securities outright by end investors. FAR members also highlighted the importance of considering both the costs and benefits of delegated asset management, and suggested that asset management had improved market liquidity, and that mutual funds help economize on transaction costs because buyers and sellers can be matched up within individual funds.

Other Topics

FAR members also considered other sources of vulnerabilities in the nonbank sector, including cyber-security risks. FAR members also discussed the recent growth in nonbank residential mortgage origination and servicing, and considered the importance of regulation, legal enforcement and other factors in driving that trend.