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Remarks

by

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Thank you for inviting me to speak today. Over the years, I have enjoyed working with many of the insurance regulators participating in this conference, and I look forward to the day—already very near—when we will again have such events in person.

The Federal Reserve has a closer connection to the insurance industry than most realize. Insurance and insurers relate closely to the Federal Reserve's mission to provide the nation with a safe, flexible, and stable financial system. Insurers play a crucial role in securing the safety and financial stability of American households. Insurers also play a key role in many financial markets, including as among the largest investors in certain asset classes.

Indeed, the Federal Reserve arguably owes its creation, which followed the Panic of 1907, at least in part to the insurance industry. Some scholars have argued that it was the catastrophic 1906 San Francisco earthquake that caused the Panic of 1907.[1] The 1906 earthquake left over half of San Francisco homeless. Such widespread destruction of one of the country's largest cities had a commensurate effect on the economy and insurance industry. Fearing that the U.S. financial markets could not absorb that many dollars in asset sales, many European insurers paid claims by withdrawing money from foreign banks and shipping gold across the Atlantic. The Bank of England's gold supply accordingly dropped 14 percent. It responded to this gold outflow with measures that contributed to the panic and, after an admittedly long chain of events, led to my being here today.

Of course, now we have a different financial system and better means to coordinate an international response to such events. One of these mechanisms is the Financial Stability Board (FSB), which I chair. Insurance continues to be an important part of the FSB's mission in

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[1] Kerry A. Odell and Marc D. Weidenmier, "Real Shock, Monetary Aftershock: The 1906 San Francisco Earthquake and the Panic of 1907," *J. Econ. Hist.* 64, no. 4 (2004): 1002–1027.

collaboration with other governments and organizations, particularly the International Association of Insurance Supervisors (IAIS).

So today, I would like to highlight a few of the Federal Reserve's priorities on insurance regulation and supervision, both domestically and internationally.

COVID Event Monitoring and Response

One priority has been monitoring the impact on the insurance industry of what I refer to as the COVID event. And so far, the insurance sector has performed very well. Insurers entered the pandemic with strong capital levels, and the industry has not seen any large defaults. Insurance risk managers and regulators should be proud of this performance.

The COVID event has also affected financial markets. The Fed continues to monitor these effects, including the impact on life insurers of sustained low interest rates. The long duration of some insurance products, paired with embedded policyholder options, can make it difficult to match cash flows and can create interest rate risk. Additionally, some savings products can be difficult for insurers to market when only returns of near 0 percent can be profitably guaranteed.

And the COVID event has posed some challenges for supervisors. Social distancing has changed how financial products are distributed, how we supervise financial institutions, and how we collaborate in the regulatory community. For example, though both the IAIS and FSB have worked intensively at a distance—there is an FSB meeting of one sort or another every day of every week—it has been over a year since the IAIS or FSB has met in person.

Capital

Currently the Board's most significant project with respect to insurance and our role in supervision is the development of a capital rule for insurance depository institution holding

companies, as required by the Dodd-Frank Act. We have engaged in a thorough and deliberative process in developing an appropriate capital rule, which has included both an advance notice of proposed rulemaking and a more recent proposal that we invited comment on. This deliberative approach is working well. Most of the comments we received on the proposal, which we're calling the Building Block Approach, or BBA, were supportive of both our process and the overall regulatory framework we proposed. And we are currently reviewing these comments and intend to publish a final rule soon.

As we near the completion of this journey, I'd like to recap why we chose to propose the Building Block Approach, which adjusts and aggregates existing legal-entity capital requirements to produce an enterprise-wide capital requirement. The BBA is meant to address one of our biggest challenges in supervising companies that engage in both banking and insurance operations, which is how different these businesses are. No single, uniform approach to capital regulation is appropriate for companies in both sectors. The banking capital framework would not appropriately assess the capitalization of insurers. It is primarily based on risk-weighted assets. This framework would not capture many of insurers' liability risks, such as from natural catastrophes. Nor would any existing insurance capital rule appropriately assess the risks of a bank.

So rather than trying to create a single capital framework that would work for all types of financial institutions, we decided to propose an aggregation approach that incorporates approaches developed specifically for each type of institution and its risks. The BBA uses the existing and time-tested frameworks that have been tailored specifically to measure appropriately particular risks. It assesses insurance risks using an insurance capital framework and banking risks using our banking capital framework.

The suitability of such an aggregation approach for regulating the capital of a large, internationally active insurance group is being debated currently at the IAIS, as I will discuss in a moment. While there are disagreements at the margins, there are also many areas of agreement on the appropriate uses of an aggregation approach. The IAIS's Insurance Capital Standard (ICS) for internationally active insurance groups itself uses an aggregation approach to incorporate non-insurance risks. And at the other extreme, there is also agreement that it would not be appropriate to calculate the capital position of a large bank holding company that is not engaged in insurance by aggregating the capital positions of certain subsidiary banks and legal entities.

A key issue in the international debate about the ICS is whether products, capital markets, and laws vary so much by country or region that a single, unified methodology cannot measure risk accurately. Are the differences in international insurance markets more like the significant differences between banking and insurance or like the less fundamental differences in the banking business models internationally? If the differences are large enough, a one-size-fits-all methodology could produce unintended consequences, send false signals to regulators or capital markets, and ultimately be destabilizing.

The Insurance Policy Advisory Committee, or IPAC, is currently studying this issue by looking at the impact of a hypothetical adoption of the IAIS' Insurance Capital Standard on the U.S. industry, markets, and consumers. The IPAC is a 21-member advisory committee that was established by Congress in 2018 to advise the Board on international insurance capital standards and other insurance issues. The group is currently performing research on the potential impact of the Insurance Capital Standard—specifically on U.S. life and retirement products—and hopes to complete a review on this in the coming months. And I'm looking forward to seeing the result.

For those that would like to contribute as a member of the IPAC, the IPAC will shortly be accepting applications.

In addition to the Insurance Policy Advisory Committee, we're also working with the states and the National Association of Insurance Commissioners (NAIC), which I want to congratulate on adopting a model law related to their Group Capital Calculation (GCC) at the end of last year. We coordinated with the states and the NAIC to ensure that there would not be unnecessary duplication and burden between our two capital frameworks. While the Building Block Approach and Group Capital Calculation cannot be exactly aligned due to reasons that include our different legal mandates and restrictions, this collaboration has been successful. As one example, no group will be subject to both the BBA and GCC. Instead, the Fed and the states will share information on groups we both supervise. This reduces unnecessary burden on firms while still allowing appropriate supervision.

Our close coordination with the states, the NAIC, and also the Federal Insurance Office extends to international policy development at the IAIS. The members of "Team USA," as we refer to this group, work together to advocate for the United States internationally. One important international project that I have already mentioned is the ICS. Two years ago, the ICS reached a milestone when the IAIS membership adopted ICS version 2.0 for use in a five-year monitoring period. The purpose of this monitoring period is to evaluate the functionality and performance of the ICS.

Team USA has argued that as currently constructed, the ICS would not be appropriate as a capital rule for U.S. internationally active insurance groups. Its market adjusted valuation approach could introduce significant volatility into the capital measure and capital requirement, which could lead to procyclical economic effects and harm the ability of insurers to provide

long-term savings products. Accordingly, Team USA and other interested jurisdictions continue to build on our work on the Group Capital Calculation and Building Block Approach to develop what the IAIS terms the Aggregation Method, which could be considered an equivalent implementation of a group capital rule for large, internationally active insurers in the United States. To accomplish that, Team USA is currently working with other IAIS members to develop criteria to assess whether the Aggregation Method and ICS have a sufficient level of comparability. These criteria are planned to be released by the IAIS for public comment at the end of this year or early next year.

As I have mentioned, it is uncertain what the potential impact of the IAIS' ICS on markets might be and whether the ICS, after any changes, will ultimately be suitable for adoption in the U.S. These issues are being studied, but the COVID event has affected this work. The number of participating firms decreased in response to the COVID event. Data analysis planned by the IAIS has been interrupted. The Fed would like to see the monitoring period extended by a year or longer given the unforeseen and unavoidable delays of the last year. This would allow for completing the originally intended analysis and incorporating any needed design changes. The Federal Reserve continues to advocate for the IAIS to have a transparent process that allows for meaningful opportunities for public comment in all its work.

Supervisory Framework

I'd also like to mention another project that we have been working on here at home. We are developing a tailored supervisory framework for the insurance savings and loan holding companies (ISLHCs) that we supervise. Our development of this framework recognizes that the risks of ISLHCs are different than other banking organizations. This supervisory framework, which we plan to publish for public comment later this year, will describe our tailored

expectations for these firms, how we will rate them, and how we rely on the work of state insurance supervisors to avoid duplication and undue burden.

Climate Change

Finally, climate change is another emerging risk that we are monitoring. Broad climate policy is the role of Congress and other federal agencies, not the Federal Reserve. The Board, however, expects all firms that it supervises, including insurance savings and loan holding companies, to manage all material risks, whatever the source—which can include climate risk. The insurance industry has been at the forefront of work to better understand climate-related financial risks, including through climate change modeling. While the Federal Reserve relies on fellow prudential regulators to supervise specific ISLHC entities, we also recognize that insurers have much to offer in understanding an emerging area of focus for the broader financial sector.

Conclusion

That is a brief summary of the Fed's work relating to the insurance industry. Our involvement with the industry is longstanding, reflecting insurance's central role in financial markets and its importance in helping households and businesses manage their risks. That involvement deepened after the global financial crisis, when Congress gave us additional responsibility for supervising certain insurers.

More recently, our involvement has included verifying that these insurers are capable of dealing with the unprecedented challenges posed by the COVID event. Another new challenge is understanding and ensuring that firms account for climate-related financial risks. And a central part of the Fed's agenda is working with other regulators and the industry to devise an appropriate approach to regulating capital—one that recognizes the unique role of insurance in the financial system and the distinctions between insurance companies and banks. Our deliberate

process has helped build confidence among regulators and the industry and is bringing us to consensus. The public, which depends on a strong and stable insurance sector, has been well-served by that process and will benefit from the outcome.

Thank you for the opportunity to speak with you. I look forward to engaging with you all in the future.