CCMR Staff Report

Non-Bank Financial Intermediation:

Insurance Companies and Asset Managers

Introduction

Non-bank Financial Intermediation "NBFI" encompasses a wide array of financial institutions with a diversity of business models, capital structures, funding sources, and risk transmission mechanisms. It is therefore critical that policymakers avoid "one-size-fits-all" NBFI regulation and instead consider the specific activities of different types of financial institutions when determining regulatory policy. Oversimplification by policymakers can lead to poor regulation, either by overburdening entities that pose minimal risk or by underestimating vulnerabilities in others. This report by the staff of the Committee on Capital Markets Regulation ("CCMR") examines the activities of insurance companies and asset managers and concludes that insurance companies and asset managers pose minimal systemic risk concerns.

I. Insurance Companies

There are two common systemic risk channels. The first channel entails loss exposure (i.e. interconnectedness), whereby losses at one institution are transmitted to other institutions through direct counterparty exposure.[1] For example, if an insurance company were to fail, creditors or other holders of its liabilities would face potential losses. However, based on our analysis of large U.S. insurance companies,[2] less than 5% of insurance company liabilities consist of short-term and long-term borrowing, while claims by individual policyholders account for more than 87% of liabilities.[3] Therefore, counterparty exposure is not a likely source of systemic risk from insurance companies.[4]

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[1] *See* Hal S. Scott, Kristin Ricci & Aaron Sarfatti, *SRISK as a Measure of Systemic Risk for Insurers: Oversimplified and Inappropriate* 4 (Sept. 12, 2016), https://www.pifsinternational.org/wp-content/uploads/2022/09/SRISK-as-a-Measure-of-Systemic-Risk-for-Insurers-Oversimplified-and-Inappropriate-2016.pdf.

[2] MetLife, Prudential, New York Life and Lincoln National.

[3] Claims include policy reserves with surrender value, policy reserves without surrender value and separate account liabilities.

[4] Counterparty exposure can be more problematic in less traditional lines of insurance company activities, such as AIG's involvement in the credit default swap (CDS) market during the 2008-2009 global financial crisis. However,

The second channel involves run risk, whereby a financial institution is forced to liquidate assets at fire-sale prices due to a run on its short-term funding. The forced asset liquidation and resulting decline in prices would potentially impose losses on other financial institutions holding similar assets. For insurance companies, run risk is relatively low due to two key characteristics of insurance company liabilities.

First, most insurance liabilities consist of long-term borrowing and insurance policies that cannot be accelerated or withdrawn by policyholders, as demonstrated by **Figure 1** on the next page. For example, the average duration of liabilities is 8 years for non-life insurance companies and 11 years for life insurance companies.[5] And, as illustrated in **Figure 1**, less than 29% of insurance company liabilities consist of surrenderable policies (e.g. life insurance policies with cash surrender value).

Moreover, those policies that are surrenderable typically include penalties or other disincentives that discourage policyholders from exercising early withdrawal options. Disincentives can include loss of insurance coverage, forfeiture of guarantees or tax penalties.[6] As a result, surrender rates are typically quite low. The American Council of Life Insurers ("ACLI") found that only 5.4% of life insurance policies were voluntarily terminated annually as of 2023.[7]

While surrender rates may conceivably increase during periods of distress, insurance policies also commonly allow the insurance company to delay payment of early withdrawal requests by up to six months, thus further mitigating any concerns about forced liquidation of assets at fire-sale prices.[8] Overall, insurance companies therefore face minimal vulnerability to the risk of runs.

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even that activity did not pose systemic risk concerns related to counterparty exposure. For a detailed analysis of this, *see* HAL S. SCOTT, CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS (2016).

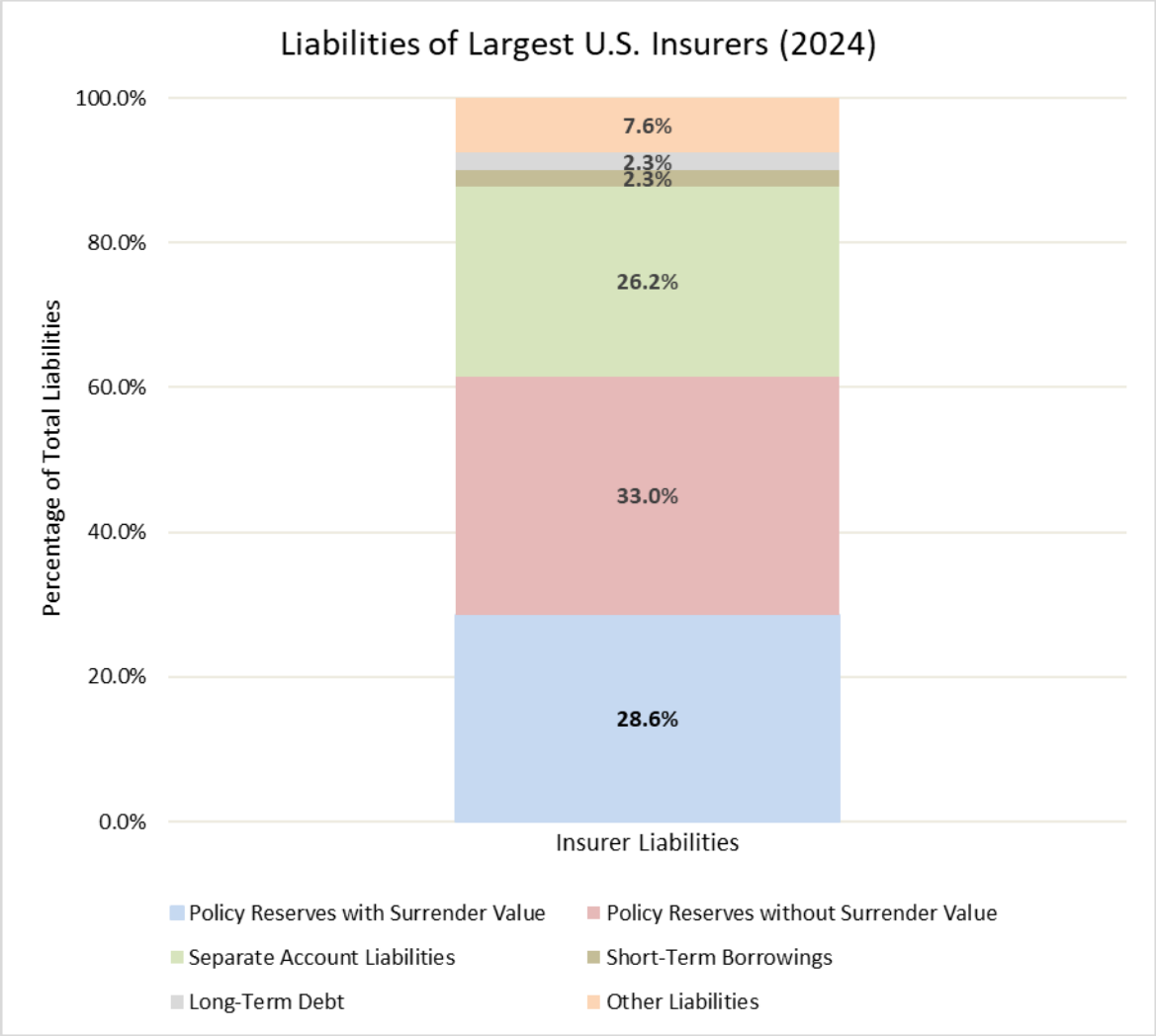
[5] Bettina Farkas et al., *Life Insurance Companies – The Missing Relief From Rising Interest Rates*, BIS Q. REV., Dec. 2023, at 14, 16 n.3, *available at* https://www.bis.org/publ/qtrpdf/r_qt2312.pdf.

[6] *See* Scott, Ricci & Sarfatti, *supra* note 1, at 7 n.14.

[7] AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2024 96 tbl.7.4 (2024), https://www.acli.com/-/media/public/pdf/news-and-analysis/publications-and-research/2024-fact-book/pub_2024aclifactbook_complete.pdf (5.4% voluntary termination rate comprised of 1% surrender rate and 4.3% lapse rate for individual life insurance policies in 2023).

[8] Scott, Ricci & Sarfatti, *supra* note 1, at 9.

Figure 1[9]



Even if an insurance company were to face liquidity pressures due to a run on its liabilities, the high-quality nature of insurance company assets would minimize potential fire sale losses. For example, as of 2023, U.S. life insurers held approximately $8.5 trillion in assets, according to the National Association of Insurance Commissioners ("NAIC") with nearly 70% invested in high-grade corporate and government securities.[10] Approximately 95% of life insurers' bond portfolios

[9] CCMR Staff analysis of Form 10-K data of Prudential, MetLife, and Lincoln National and statutory financial statement data of New York Life.

[10] MICHELE WONG, NAT'L ASSOC. OF INS. COMM'RS, U.S. INSURANCE INDUSTRY'S CASH AND INVESTED ASSETS RISE TO $8.5 TRILLION AT YEAR-END 2023 1, 3 tbl.1 (2024), https://content.naic.org/sites/default/files/capital-markets-special-reports-asset-mix-ye2023.pdf

consist of investment grade bonds.[11] These investments are matched to the duration of liabilities to ensure solvency during periods of financial stress.

Empirical research also finds that insurance companies weather market downturns without significant risk of insolvency.[12] Insurance companies also provide a significant stabilizing effect during periods of market stress. For example, empirical research shows that bonds held by insurance companies experience significantly lower price declines during market downturns than bonds held by other financial institutions.[13] The stabilizing impact of insurers has real economic benefits to the corporate issuers of these bonds, as they face lower financing costs and an increased likelihood of raising additional funds.[14]

The relative resiliency of the traditional U.S. insurance sector was highlighted during the 2008-2009 global financial crisis ("GFC"). U.S. insurance companies weathered the crisis relatively unscathed in large part due to a combination of self-funding through collection of insurance premiums, lack of reliance on short-term funding, lack of leverage, and high levels of substitutability. The systemic risk posed by AIG was not from its traditional life and property insurance activities. Rather, AIG's large losses and liquidity crisis were due to the credit default swaps ("CDS") that AIG Financial Products sold on multi-sector collateralized debt obligations that were exposed to U.S. subprime mortgages[15] and reinvestment of cash collateral in mortgage-backed securities by AIG's securities-lending subsidiary.[16] Importantly, subsequent regulations have addressed the concerns associated with CDS activity, namely through central clearing and reporting requirements for CDS transactions.[17]

The experience of AIG as compared to other insurers engaged in more traditional insurance activities highlights that even within the insurance sector not all firms should be treated equally from a systemic risk perspective, let alone across the entire NBFI domain. Just as insurance

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[11] *Id.* at 6.
[12] *See* Gabriel Chodorow-Reich et al., *Asset Insulators*, 34 REV. FIN. STUD. 1509 (2021).
[13] Antonio Coppola, *In Safe Hands: The Financial and Real Impact of Investor Composition over the Credit Cycle*, REV. FIN. STUD. (forthcoming 2025).
[14] *Id.*
[15] *See* Hal S. Scott, *Interconnectedness and Contagion* 70 (Nov. 21, 2012) (discussion paper), https://capmktsreg.org/wp-content/uploads/2022/11/2012.11.20_Interconnectedness_and_Contagion-1.pdf.
[16] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, 272, 345, 376-77 (2011).
[17] *See* Wall Street Transparency and Accountability Act of 2010, Pub. L. No. 111-203, tit. 7, 124 Stat. 1380 (codified in scattered sections of 7 U.S.C. and 15 U.S.C.).

companies that engage in "non-traditional" insurance activities on significant scale should be viewed differently from more traditional insurers, the same applies for all NBFIs. Regulatory approaches that are sector-specific in this respect are best positioned to identify the relevant activities of financial institutions, as opposed to broad-based NBFI regulation that would fail to distinguish these differing activities.

II. Asset Managers

Asset managers, who oversee $128 trillion in global assets under management ("AUM") as of 2023,[18] play a central role in the financial system. However, despite the large global scale of the asset management industry, as measured by AUM, the asset management industry does not pose systemic risk concerns as neither the failure of an asset manager nor any individual investment fund would destabilize financial markets.

An asset manager's assets under management are *owned* by clients and held by a custodian. As a result, asset managers assume very little balance sheet risk, since investors' funds are held either in independent legal entities or in segregated accounts that are legally distinct from the asset manager's assets. Client assets would not be drawn into the liquidation or bankruptcy of the asset manager, ensuring that client portfolios remain protected in such cases.

The resolution process of an asset manager is straightforward from the perspective of investors and involves the reassignment or transfer of their assets to another asset management firm or investment fund.[19] Such reassignment is easily achieved, because of the intense competition and low level of concentration in the asset management industry.[20] Liquidation of failing asset managers has regularly taken place through several mechanisms, including: open market sales, private commitments from market participants, or through the traditional bankruptcy process. Therefore, resolution of a failed asset manager would not have an adverse effect on financial stability. For example, in 2011, AXA Rosenburg substantially restructured its business after concealing a model error that produced substantial losses. Although the firm's initial $62 billion AUM declined by nearly one third—a dollar amount almost four times as large as the credit default

[18] THINKING AHEAD INST. & PENSIONS & INVS., THE WORLD'S LARGEST 500 ASSET MANAGERS 5 (2024), https://www.thinkingaheadinstitute.org/content/uploads/2024/10/PI-500-2024.pdf.
[19] *See* Letter from the Comm. on Capital Mkts. Reg. to the Secretariat, Fin. Stability Bd. 7 (Apr. 7, 2014).
[20] *See* Letter from Comm. on Capital Mkts. Reg. to Fin. Stability Oversight Council 2-3 (Mar. 16, 2015).

swap payments triggered by the bankruptcy of Lehman Brothers—there was no disruption to the broader market.[21]

Aside from the asset manager itself, the failure of any individual investment fund would also not pose financial stability concerns. As CCMR has noted previously, investment funds do not provide significant levels of short-term funding to large banking institutions, so the collapse of any particular fund would not trigger funding problems at these banks.[22] Moreover, large banks do not have significant investments in investment funds, so they would not be directly exposed to losses that may result from a fund's collapse.[23] Investment funds, like asset managers, are frequently liquidated without triggering any financial stability concerns.[24] Overall, neither the failure of the asset manager nor one of its individual investment funds would pose significant systemic risk concerns to the financial system.

III. Conclusion

The systemic risk profiles of insurance companies and asset managers illustrate the dangers of a one-size-fits-all regulatory approach to NBFIs. Treating these entities as a monolithic group risks overregulating sectors like insurance and asset management, which pose minimal systemic risk. Policymakers must instead adopt a data-driven, targeted regulatory framework that tailors oversight to the specific characteristics of each NBFI category. By recognizing the heterogeneity of the NBFI sector, regulators can achieve a balance between safeguarding financial stability and fostering innovation and efficiency.

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[21] Letter from the Comm. on Capital Mkts. Reg. to the Secretariat, Fin. Stability Bd. 4 (May 29, 2015).
[22] *See* Letter from the Comm. on Capital Mkts. Reg. to Randal K. Quarles, Chair, Fin. Stability Bd. and Shane Worner, Int'l Org. of Sec. Comm'ns 3 & n.9 (Aug. 26, 2019).
[23] *Id.* at 3.
[24] *Id.*