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Invited Article III

Tao of Macroprudential Supervision—Yin and Yang

by Mack Okubo[*]

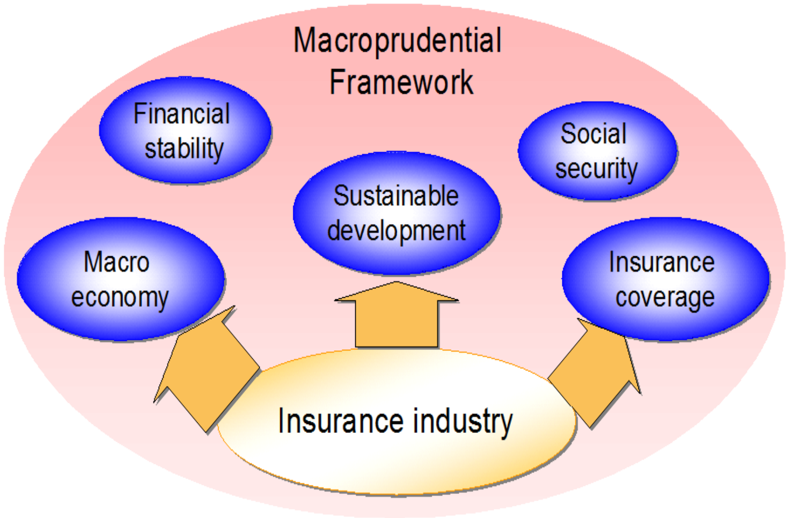
Introduction

Responding to the financial crisis, financial stability has become one of the core topics in the global financial regulatory agenda, including the insurance sector. The IAIS has recently incorporated macro-prudential aspects into the Insurance Core Principles (new ICP24 macroprudential supervision and analysis) and is enhancing a macroprudential surveillance framework, while it is developing methodology to assess systemic relevance in insurance and measures for those insurers identified as systemically important.

In this article, I would like to share my thoughts[1] on the framework for Macroprudential supervision, including the issue of pro-cyclicality. Also, I'd like to share the experience of Japan. And as a conclusion, I would like to share my insights about what we can learn from the ancient Chinese philosopher in order to address the financial crisis that we have faced recently.

Macroprudential Framework—what is missing?

The Macroprudential Framework would not mean merely the monitoring of systemic risks, but should holistically cover all the key dimensions. For example, what would be the impact on the macroeconomy? How can insurers support sustainable development? How can insurers play a role in social security systems? How can consumers purchase insurance coverage at affordable prices? All those factors should be incorporated when you talk about a Macroprudential Framework. Of course, it would complement a Microprudential Framework, which would focus on the financial soundness of each financial institution, as well as the protection of its customers.



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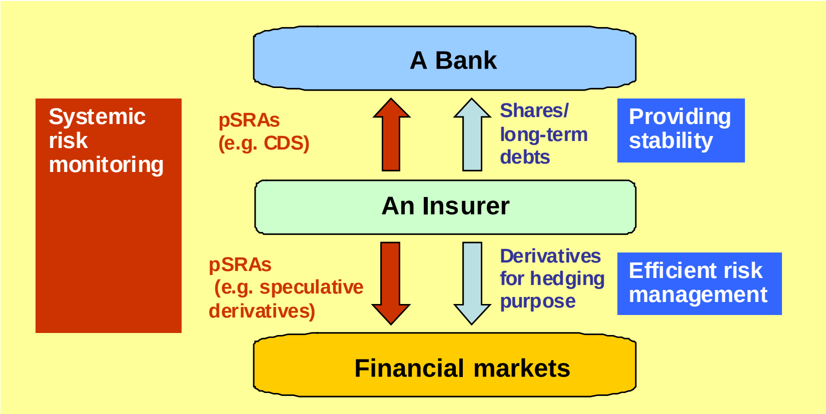
[1] This article is based on a presentation for the Macroprudential Surveillance Panel of the IAIS Annual Conference on 29 September 2011 in Seoul, South Korea.

A "Mic-Mac combination" is important to avoid the fallacy of compositions that may arise if you focus too much on the Microprudential Framework.

Since they are part of the settlement system, monitoring of systemic risk appears at the heart of the macroprudential surveillance. On the other hand, I believe that macroprudential supervision for insurers should take a more holistic approach because insurers have a lot of different responsibilities with more relative importance. Of course, we have to monitor systemic risk, but it should be monitored focusing on potentially systemically risky activities (pSRAs).[2] It would actually contribute to reducing regulatory arbitrage. In order to underwrite core insurance business, you have to be licensed as an insurer. Banks cannot underwrite insurance as banks. Regulatory arbitrage can therefore be dealt with by focusing on systemically risky activities which are of a similar nature.



This table summarises my idea about the inter-linkage between an insurer and a bank as well as financial markets. Systemic risk monitoring should focus on pSRAs. For example, the recent crisis was sparked by massive CDS products with possible liquidity implications. Also, speculative derivatives may have created some issues in the financial markets. On the other hand, there might be inter-linkage between banks and insurance companies through investment, such as shares and long-term debts. Don't forget that those provide stability to the system. And there are derivatives for hedging purposes, which contribute to insurance companies' efficient risk management.

Pro-cyclicality—how to avoid unintended consequences?

There would be an adverse impact on the insurance and financial market if the International Financial Reporting Standards (IFRS 4) as proposed by the International Accounting Standards Board (IASB) were applied to insurers. That would create significant volatility for long-term products, which may drive insurers to transfer most risks over to customers. It may raise some issues in jurisdictions where customers want long-term guarantees. It may refrain insurers from investing in non-fixed income assets. That may create some pro-cyclicality concerns.

Similar consequences might occur if an economic-based solvency regime were implemented improperly. Instead of taking one hour to discuss the issue, I would recommend you to read some very interesting reports. One is published by the BIS, the Committee on the Global Financial System (CGFS).[3] Another one is published by the Institute of International Finance (IIF).[4] They analyse potential consequences arising from the discussions on insurance regulatory requirements.

Unintended consequences on financial stability might occur if the Basel III or G-SIFI capital surcharge were applied to insurers. Basel III should not enter insurance. I remind you that not only the business models but also the regulatory models are different between banks and insurance companies.

I would like to use an analogy: children going swimming at the beach. The mother tells the children: "Don't go too far away from the seashore. You have to keep the height higher than the depth with a sufficient margin. Otherwise, it would be dangerous." But the father tells the children: "You have to know how to swim, because swimming with the tide is even safer" and gives them more freedom. The

[2] Speculative derivatives or mismanaged short-term funding are examples indicated in The Geneva Association paper *Systemic Risk in Insurance—An analysis of insurance and financial stability* (March 2010). Available at: *http://www.genevaassociation.org/PDF/BookandMonographs/Geneva_Association_Systemic_Risk_in_Insurance_Report_March2010.pdf*

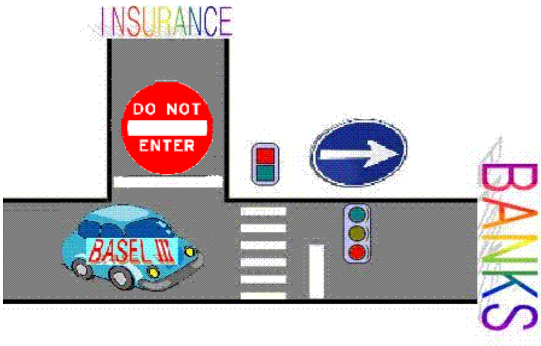
[3] Committee on the Global Financial System (2011) *Fixed income strategies of insurance companies and pension funds,* CGFS, BIS, July. Available at: *http://www.bis.org/press/p110712.htm*.

[4] Institute of International Finance (2011) *The Implications of Financial Regulatory Reform for the Insurance Industry,* IIF, August. Available at: *http://www.iif.com/download.php?id=iW5B5vLpNSE*.

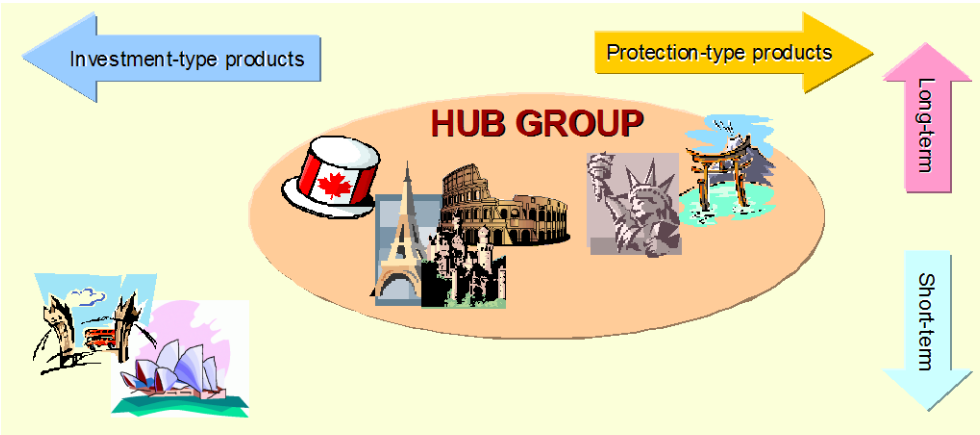
mother sounds like a banking regulator, and the father like an insurance regulator. After the crisis, after hearing a rumour of a big wave, the Mother is putting pressure on the Father, "As you are their father, tell them that they can swim but only near the seashore." And the children are complaining about it. "I can't swim properly here because it is not deep enough!"

I would rather give my son floating devices and oxygen-providing devices. Insurance regulation should be tailor-made for insurers.

In addition, Basel III appears to have many strict capital requirements, including deductions. If it were copied for insurers, it would be difficult for them to play an important role as significant long-term investors. Currently, insurers are providing stability to the financial system, holding investments for a long time. We are supporting society and sustainable development. Don't discourage us to play such a role. Don't try to break all the bridges crossing the river, simply because they may collapse in the future. That would simply reduce some uncertainty, but would not solve the financial stability problem.



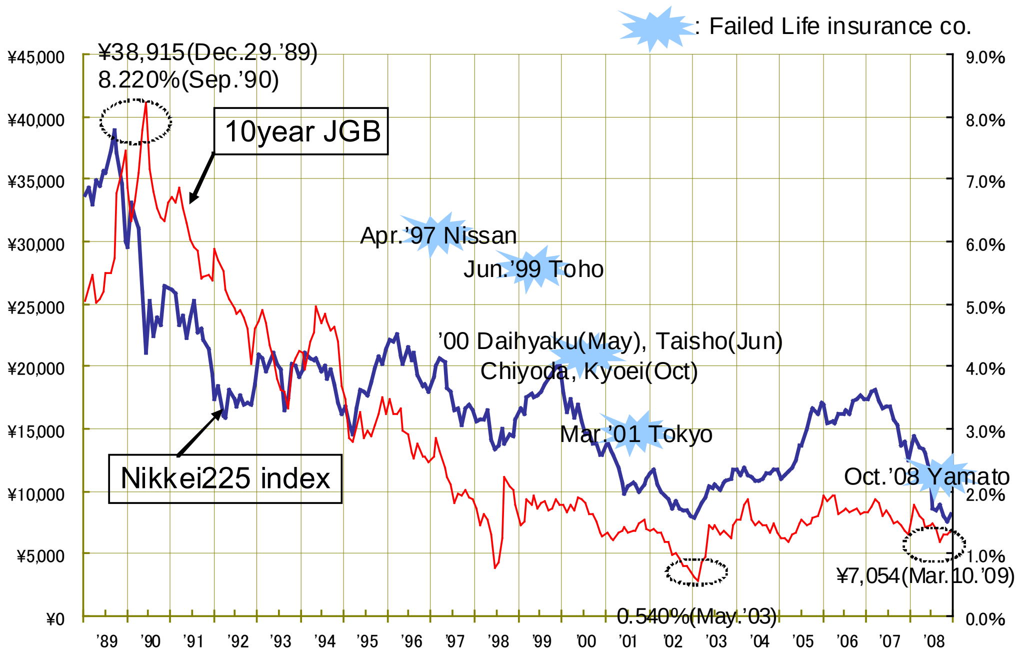
The implications would be different by jurisdiction, due to different business models that reflect the customers' preferences and needs, the expected roles of the insurers, and the state of development of financial markets. In many countries, long-term debt markets are not well-developed to correspond to all insurers' long-term insurance liabilities. Those are reflected in the business models which are different jurisdiction by jurisdiction.



I have carried out research on these countries: the U.K., France, Germany, the U.S., Canada, Australia and Japan. I found a clear linkage between their business models and solvency and accounting regimes, including the scope of their use of IFRS. If you look at the U.K. and Australia, short-term investment-type products dominate the market. On the other hand, in continental Europe, North America, Japan and many emerging market jurisdictions, long-term protection products cover a significant portion of the market. Life insurers tend to play a role as long-term investors. For those jurisdictions, there may be a big impact if there is too much sensitivity to short-term fluctuations. It should be noted that the Hub group, which is working on that matter, is represented by the countries where the impact is significant.

Japanese experience: low interest rate environment

As you may probably know, Japan has experienced a low interest rate environment for many years. This is a global trend, but Japanese interest rates have been so low for a long time—over 10 years. Those low interest rates may have helped banks to recover from their assets problems, but they caused hardship to insurers.



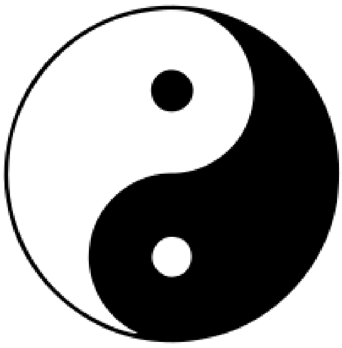
Low interest rates together with disappointing stock prices caused a number of life insolvencies in the 1990s. Seven life insurance companies went insolvent in a very short time. At that time, Nippon Life had a chairmanship and had to deal with the winding-up of the companies. It was a very tough time. Nevertheless, systemic events were not observed. Some may argue that those problems were related and somewhat systemic. But they were not, because their products were not part of the settlement system. No company went insolvent directly because of the failure of another one. These companies offered higher guarantees than the market rate. This led to their insolvencies. But there was no connection between the companies. This was a microprudential issue but not a macroprudential issue. The two should be distinguished very clearly.

And of course, most Japanese life insurers have survived. If you look at interest rates, they have been low for a long time, but at least they have been stable. Believe it or not, the Japanese life insurance industry as a whole has reported basic profits of somewhere between ¥2-3tn each year for the past 10 years. The life insurance business is such a stable business.

How have most Japanese life insurers survived? First, we have other sources of profits: mortality. We have very conservative assumed mortality rates. As you probably know, Japanese people don't die very easily. We have earthquakes. We have typhoons. We don't take vacations. But still our life expectancy is the longest in the world. Probably, we may be too busy to die. Also, Japanese companies made great efforts to enhance efficiencies that give reduced expenses, which is another source of profits. We have a conservative valuation system as well as provisions, such as the price fluctuation reserve, from which we can deduct when we encounter difficult times. Also, we have long-term management. In a life insurance company, the first ten years may be regarded as a training period. We have a very long-term vision. We don't seek short-term profits by taking risks. That style of management has been very helpful to keep a stable business. These may be lessons learned from the Japanese experience.

Conclusion: yin and yang

Macroprudential surveillance should be a part of the holistic framework. This is in line with the Eastern philosophy: Yin and Yang is the core of Taoism. In Eastern medicine, which is quite different from that of Western medicine, doctors don't touch just your shoulders if you have a shoulder-ache. They look at your whole body from a distance, to find any place that has an imbalance. You have to treat that part and then shoulder-ache will naturally disappear. I believe that looking only at systemic risk is like touching just your shoulder when you have a shoulder-ache. You may be feeling fine, but the problem will not disappear. You should take a more holistic approach and this is how macroprudential surveillance should be designed.



There are other words from Taoism. Taoism says that we should be aware that the world is cyclical. We have good times, we have bad times. So, we have to prepare to incorporate and absorb all the different changes. Asians tend to think this way all the time. We tend to feel concerned when we have a very good time, and we tend to be encouraged during a difficult times. This is why Asians look happy these days.

And then, Taoism says “Don’t go to the extreme, otherwise you will fall.” For them, it’s good to be strong. But if you go too strong, that would become your weakness. We should bring the balance of yin and yang to the universe, even in supervision. Of course, it’s good to have sufficient capital for the stability of the system. But if it becomes excessive, then insurance companies will start selling assets, and maybe customers will find it difficult to buy insurance at such high prices. That would be negative to stability. You have to have a good balance. If you focus on macroprudential, it’s okay. But if you go too far, that would harm microprudential regulations protecting consumers. So, you have to keep a good balance of yin and yang. This, I think, is of core importance.

Another weird sounding principle of Taoism is that in order to go in one direction, you have to start from the opposite. This is a very basic principle of Taoism. In order to go inside, you have to go outside. It’s complicated, but I am of the opinion that it may be true. I formerly conducted research on banking regulations. I even attended seminars designed for bank lawyers. But I’m an Asian, and my objective was not to apply those regulations to insurance. My objective was to understand deeply what insurance is all about, and how insurance is different from banking, in order to design a insurance regulatory regime that reflects the specific nature of the insurance sector.

Taoism also says: “In order to manage the world, you should control yourself.” In order to implement international standards, you should first know your own country. What are your products, what about your markets, what roles the companies play in your country. Just copying and pasting different systems without knowing your own country would produce unexpected consequences. You can’t have your organs transplanted without your blood type being known.

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