

International Association of Insurance Supervisors (IAIS)
position statement on key financial stability issues
4 June 2010



Executive Summary

A. The insurance sector is susceptible to systemic risks generated in other parts of the financial sector. For most classes of insurance, however, there is little evidence of insurance either generating or amplifying systemic risk, within the financial system itself or in the real economy.

B. There are also some circumstances where insurers may amplify risk, for example life insurers reacting to downturns in equity markets, or where they may disrupt for a period a segment of the real economy through an unexpected withdrawal of capacity. An effective regime of regulation and supervision can mitigate these possibilities.

C. Non-regulated entities of financial conglomerates and some specific insurance activities (such as financial guarantee insurance) can generate or amplify systemic risk and may be instrumental to contagion within conglomerates or between sectors.

D. Since interdependencies between the sectors may increase in the future through products, markets and conglomerates, the IAIS is promoting enhancements to supervision and supervisory processes, combined with stronger risk management and enhanced approaches to resolvability to minimise adverse externalities. These enhancements include group-wide supervision and the development of a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). The IAIS is also promoting cross-sectoral macro-prudential monitoring of potential build-up of systemic risk and planning to develop measures for national authorities to assess degrees of systemic risk.

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Introduction

1. The insurance industry is an important part of the global financial system and economy. As the international standard setter for insurance, the IAIS has been analysing the potential for financial instability in this sector to determine what, if any, regulatory and supervisory action might be appropriate. We have examined many risks and circumstances where systemic risk might apply to the insurance sector regardless of whether these circumstances emanate from the insurance sector or are merely transmitted to the insurance sector from another financial sector.
2. The purpose of this note is to outline the IAIS position on key financial stability issues in insurance. To set the stage for the analysis, the basic insurance business model is described. Following this, the potential systemic risk of the insurance sector is discussed. We then consider the applicability to insurance of recognised systemic characteristics and insurance resolution, respectively, and conclude with some supervisory enhancements for insurance proposed by the IAIS.

Insurance Business Model

3. Traditionally the primary purpose of insurance is to indemnify policyholders (both individuals and corporations) from claims associated with adverse events (e.g., property damage, premature death, liability claims, etc.) and to provide stable long term savings during the lifetime of a person. Diversification of risk is the main tool used in this process; diversification takes place by pooling policyholders' risks, by insuring a wide variety of policyholder pools, by underwriting in different geographic areas and by diversifying across different types of risks (such as underwriting and investment risk).
4. To the extent that risk remains after diversification, further mitigation techniques are used by insurers, including reinsurance, hedging, insurance linked securities and the use of separate accounts for certain life insurance products (whereby policyholders take most or all investment risk). Generally, insurers incorporate strong risk management practices, including asset-liability management, to mitigate asset and liability mismatches. In addition, supervisory processes and regulatory requirements (such as capital and claim provisioning requirements) help to maintain solvency in the industry.
5. In spite of this, insurers sometimes become financially distressed and, in a competitive market, financial distress and insolvencies may occur from time to time. The financial distress of an insurer usually plays out over a long time horizon. That is, assets of the insurer do not need to be liquidated until claims or benefits under the policies need to be paid, and this will not occur until months or even years in the future. Accordingly, regulators usually have the time to intervene to reduce potential losses to policyholders from the insolvency.

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6. Insurers and banks share some common characteristics and risks because they are both financial intermediaries (for example, financial guarantee insurance bears some similarity to banking type products); however, the roles of banks and insurers in the economy differ substantially. That is, banks are part of the payment and settlement system and are involved in the transmission of monetary policy, while insurers are not. Banks tend to rely to a larger extent on short term borrowed money, and hence are exposed to liquidity risk; on the other hand, insurers receive premium payments in advance of claims so that liquidity risk is not usually an issue.

Systemic Relevance and Systemic Risk

7. The insurance sector is susceptible to systemic risks generated in other parts of the financial sector. For most classes of insurance, however, there is little evidence of insurance either generating or amplifying systemic risk, within the financial system itself or in the real economy. This is because of the fundamentally different role of insurers in the economy as compared to banks. It is important also to note the stabilisation role that the insurance sector typically plays in the economy that may help to limit systemic risk.
8. The G20, IMF, FSB and BIS focus on three characteristics of systemically important financial institutions: size, interconnectedness and substitutability. This section analyses the applicability of these characteristics to insurance.
9. By itself, size is not a particularly good measure for assessing the potential for systemic risk in insurance. In fact, size has a beneficial effect for most insurers by allowing for greater diversification of risk (via the law of large numbers). Also, because premiums are funded in advance of claims, insurers typically are required by operation of the business model and regulatory requirements to have a large amount of assets on hand relative to liabilities in comparison to banks, which can be critical in the event of an insolvency.
10. Reinsurance activities help redistribute risks among insurers, but also contribute to interconnectedness within the insurance sector. Hypothetical systemic events of failure of a large reinsurer and/or a reinsurance spiral (neither of which have occurred to date) could conceivably have a significant impact on capacity among primary insurers and cause disruption to the real economy. IAIS monitors this with its Global Reinsurance Market Report, which suggests that reinsurance risk exposures have so far been well managed and diversified.
11. Insurers are certainly interconnected with other financial and non-financial firms through equity shareholdings, corporate debt holdings, other investments, treasury operations, securities lending etc. However, whether these interconnections are of systemic importance would depend on how much the total exposure of insurers' investments account for in the overall economy. Further, as already indicated, immediate liquidation of an insurer's investments does not occur when an insurer becomes insolvent. Hence, a fire-sale of large blocks of investments which might depress asset prices does not typically occur in an insurer insolvency.

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- 12.** Lack of substitutability in the insurance sector may lead to market disruptions, especially when insurance coverage is necessary to conduct business. For example, a market disruption can occur when compulsory insurance products become unavailable. Also, insurance against catastrophes can become unavailable or extremely costly after a catastrophic event. There is also a possibility that a market failure will occur where insurance capacity disappears in a particular segment of the insurance market such that parts of the real economy are disrupted and government intervention is required. Market disruptions or failures of this nature are typically relatively short term, as new insurers and/or reinsurers can usually move into the affected region to create capacity for the product(s) in question, although this is not always the case. An effective regime of regulation and supervision can mitigate this possibility.
- 13.** An important part of the IAIS analysis has been exploring ways in which insurers may amplify systemic risk under certain circumstances. For example, the participation of life insurers in capital markets can contribute to selling pressure, if the insurers collectively hold significant positions in equities or hedging instruments and need to liquidate their positions simultaneously in a falling market.
- 14.** Of course, as conditions change in the future, in theory the possibility exists that insurers may become systemically important. Some cases where insurers might generate systemic risk include: (1) widespread distribution of financial products that contain a minimum guarantee and/or distribution of other types of banking-like products; (2) widespread (naked) derivatives trading, especially extensive distribution of credit default swaps (CDSs); (3) expansive offering of financial guarantee insurance; and (4) insurers using regulatory arbitrage to offer products or services that end up being systemically important.
- 15.** Indeed, the nature of the insurance industry has already been changing. Some parts of the industry have been growing in complexity, diversity and global reach. Financial innovation and the rapidly changing financial environment have contributed to the formation of some insurance entities and groups spanning jurisdictional borders and/or sectors. In light of continuing financial instability since 2007, there has been an increased focus, by many parties, on issues of financial stability and the risks associated with large and complex financial organisations operating on a cross-border and/or cross-sector basis.
- 16.** Non-regulated entities of financial conglomerates (as in the case of AIG) and some insurance activities (such as financial guarantee insurance) can generate or amplify systemic risk and may be instrumental to contagion within conglomerates or between sectors. Further, contagion effects might also occur if a member of a group exhibits financial distress.

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Resolvability

17. The ease with which an insolvent insurer can be resolved depends on many factors, including the role of insurance guarantee schemes, where they exist. For insurers (unlike banks), there can be 'life after death'. That is, failed insurers often can be managed through orderly run-off, and sometimes even brought back to life with new capital.
18. All insurers are regulated at the solo entity (company) level. However, there is widespread recognition that the resolvability of internationally operating financial entities, groups, or conglomerates poses remarkable legal challenges. Enhanced supervisory oversight for such entities is underway and cooperation with other sectors will be required.

Proposed Supervisory Enhancements

19. The IAIS agrees that it is necessary for insurers and insurance groups to be supervised on a solo entity basis and on a group-wide basis. Group supervision should include consideration of non-regulated entities and/or non-operating holding companies within a group. Other supervisory enhancements are under consideration and/or development (particularly in cooperation with the Joint Forum) to reduce the potential for regulatory arbitrage. These enhancements should reduce the probability and potential impact of future insolvencies and insurance market failures. The enhancements should increase the role of insurers as stabilisers and decrease their potential susceptibility to systemic risk or their roles as potential transmitters or amplifiers of systemic risk. The enhanced insurance supervisory framework should contribute to financial stability and should also improve micro-prudential supervision and policyholder protection.
20. Since interdependencies between the sectors may increase in the future through products, markets and conglomerates, the IAIS is promoting enhancements to supervision and supervisory processes, combined with stronger risk management and enhanced approaches to resolvability to minimise adverse externalities. These enhancements include group-wide supervision and the development of a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). The IAIS is also promoting cross-sectoral macro-prudential monitoring of potential build-up of systemic risk and planning to develop measures for national authorities to assess degrees of systemic risk.