International Association of Insurance Supervisors

Press release

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IAIS releases paper on Insurance and Financial Stability

The International Association of Insurance Supervisors (IAIS) released a paper today entitled *Insurance and Financial Stability* providing the perspective of insurance supervisors on the role of the insurance industry and its interaction with the financial system and other financial market institutions.

The recent financial crisis has shown that the traditional insurance business model enabled the majority of insurers to withstand the crisis considerably well. The report observes that insurance underwriting risks are in most cases not correlated with the economic business cycle and financial market risks and that the magnitude of insurance liabilities are, in very broad terms, not affected by financial market losses. While impacted by the financial crisis, insurers engaged in traditional insurance activities were not a concern from a systemic risk perspective.

However, the financial crisis revealed that insurance groups and conglomerates operating in traditional lines of business may suffer considerable distress and become globally systemically important when they expand significantly in non-traditional and non-insurance activities. The paper describes how insurance groups and conglomerates that engage in non-traditional or non-insurance activities are more vulnerable to financial market developments and thus more likely to amplify, or contribute to, systemic risk. Examples of such non-traditional and non-insurance activities include credit default swaps (CDS) transactions for non-hedging purposes or leveraging assets to enhance investment returns.

Peter Braumüller, Chairman of the IAIS Financial Stability Committee, noted: “Based on information analysed to date, for most lines of business there is little evidence that traditional insurance generates or amplifies systemic risk within the financial system or the real economy. However, supervisors need to monitor very closely those insurance activities that deviate from the traditional insurance business model.” He added: “The differences in the impact of failures of insurers and banks should be reflected in the measures applied.”

About the IAIS: The IAIS is a global standard setting body whose objectives are to promote effective and globally consistent regulation and supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders, and to contribute to global financial stability. Its membership includes insurance regulators and supervisors from over 190 jurisdictions in some 140 countries. More than 120 organisations and individuals representing professional associations, insurance and reinsurance companies, international financial institutions, consultants and other professionals are observers.

Note to editors:

The paper *Insurance and Financial Stability* is available at **http://www.iaisweb.org/Other-papers-and-reports-46**

Specific questions regarding the report may be sent to the IAIS Secretariat by e-mail (IAIS@bis.org) or fax (+41 61 280 9151).

Media representatives are invited to a conference call with Peter Braumüller, Chairman of the IAIS Financial Stability Committee, on Tuesday, 15 November, starting at 2:00 p.m. CET. IAIS Members and Observers may listen in.

Please dial-in to register approximately 5 to 10 minutes prior to the start of the call.

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Appendix

Insurance and Financial Stability – Executive Summary

1. **This paper presents a supervisory perspective on the (re)insurance sector and on financial stability issues.** It analyses the sector's role in the financial markets, including its interaction with other financial institutions, and its impact on the real economy. In addition, the International Association of Insurance Supervisors (IAIS) endeavours to clarify the rationale of its proposed methodology to identify any institutions "whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruptions to the wider financial system and economic activity. "[1]

2. **The business model exposes insurers to unique risks, which are not typically found in banking**. Unique in insurance underwriting are, for example, mortality, morbidity, property and liability risks. Insurers are, however, also exposed to risks found in other financial institutions including credit risks, operational risks, and market risks related to equity investments as well as movements in interest rates and exchange rates. While these risks are not unique to insurance, they can arise in unique ways as result of the specific business model.

3. **The financial crisis of 2008/09 has shown that, in general, the insurance business model enabled the majority of insurers to withstand the financial crisis better than other financial institutions.** This reflects the fact that insurance underwriting risks are, in general, not correlated with the economic business cycle and financial market risks and that the magnitude of insurance liabilities was, in very broad terms, not affected by financial market losses.[2] Moreover, insurers' investment portfolios, which are selected largely to match the underlying characteristics of insurance liabilities, were able to absorb sizeable losses. Similarly, the nature of insurance liabilities, and the fact that payments to policyholders generally require the occurrence of an insured event, makes it less likely for insurers engaged in traditional activities to suffer sudden cash runs that would drain liquidity. While impacted by the financial crisis, insurers engaged in traditional insurance activities were largely not a concern from a systemic risk perspective.

4. **However, insurance groups and conglomerates that engage in non-traditional or non-insurance activities are more vulnerable to financial market developments and importantly more likely to amplify, or contribute to, systemic risk.** Examples of non-traditional and non-insurance activities include credit default swaps (CDS) transactions for non-hedging purposes or leveraging assets to enhance investment returns. In addition, the

[1] This adopts the FSB definition given in: "Reducing the moral hazard posed by systemically important financial institutions", Financial Stability Board (FSB), October 2010. The methodology to determine the potential systemic importance of insurance-focused groups and conglomerates will likely differ from the banking approach to reflect the specific nature of the insurance business.

[2] The exception being special lines, such as Lenders Mortgage Insurance, Directors & Officers (D&O) coverage, Credit Insurance and Trade Credit Insurance, or certain activities defined as non-traditional in section 3.2 of this paper, such as Financial Guarantee Insurance (FGI), which by their nature are closely related to the business cycle and to financial market volatility.

continually evolving marketplace is resulting in products and activities that blur the lines between traditional insurance and bank-type (or investment bank-type) activities. The recent financial crisis has revealed that even financially strong insurance groups and conglomerates operating on a core of traditional lines of business may suffer significant distress and become globally systemically important when they expand significantly in non-traditional and non-insurance activities. In this context, it is important to distinguish between those activities that are regulated as insurance and those that are not.

5. **Insurance markets are competitive**. While the insurance business is considered to be predominantly local, competition in most lines of business, especially in traditional insurance, tends to be strong. The larger groups are exposed to global competition only in the context of large risk covers. These dynamics suggest that substitutability, or the continuation of supply of insurance coverage after a failure of a single entity, is likely a less material issue in insurance than in banking.

6. **Exceptions may arise through high supplier concentrations in certain market niches**. In monopolistic or oligopolistic market niches the failure of a dominant insurer could create temporary distortions materialising in the unavailability of cover and sharp price increases. However, such distortions tend to be limited to local markets and they are generally of short duration (see the case study on HIH in appendix A10). Considerable price fluctuations in non-life insurance have been observed also after capacity losses caused by large natural catastrophes. But capacity tends to be restored quickly. The restoration of capacity tends to occur to a large part through the inflow of new capital, since barriers to market entry tend to be low in many lines of business. The restored supply capacity exerts downward pressure on prices, and in most cases they return to previous levels (see also discussion in point 42 below).

7. **Insurers connect to the financial markets through their investments, capital raising and debt issuance.** In Europe, insurance groups hold a sizeable portion of their investments in securities issued by other financial institutions, predominantly debt instruments, and to a very small degree, equity securities.[3] The ability - and willingness - of insurers to make such investments provides an important contribution to the financial soundness of banks and more broadly to financial stability.[4] In a similar fashion insurers are also allocating capital to the real economy by purchasing debt securities of industrial companies or through real estate investments. These activities underscore the importance of a financially sound and stable insurance sector. In turn, investment activities expose insurers to the volatility of the sectors in which they invest.

8. **Just as the insurance business model is different from the banking model, the impact of insurance failures on other financial institutions and the real economy is different.** The reasons for the differences in impact reside in the particulars of the insurance business model; in the disciplined implementation of a predominantly liability-driven invest-

3 "Systemic Risk in Insurance, An analysis of insurance and financial stability," Geneva Association 2010.

4 This point was taken up in a study by the Basel Committee on the Global Financial System (CGFS); see: "Fixed income strategies of insurance companies and pension funds," *CGFS papers*, June 2011. It should be noted that the holdings of debt securities issued by other financial institutions varies considerably between jurisdictions.

ment approach; in the nature of insurance claims that in many cases allow the management of cash outflows over an extended period of time (from weeks to months to years, depending on the line of business); and in the high degree of substitutability, allowing for a comparatively ease of market entry into most lines of business.

9. **The answer to the question whether insurers could cause systemic risk is ultimately an empirical issue.** However, based on information analysed to date, for most lines of business there is little evidence of traditional insurance either generating or amplifying systemic risk within the financial system or in the real economy. Of course, empirical assessments about the systemic importance of insurers and insurance groups may change over time. A benign record in the past does not ensure the absence of a systemic risk potential in the future. That is why the IAIS is committed to reviewing the pace of innovation and changes in insurance business models as well as in the complex interactions within insurance groups at regular intervals. It will also continue to analyse the role of reinsurers in the context of financial stability.

10. **The differences between insurers and banks in the impact of failures suggest *inter alia* that requirements for loss absorbency and resolution regimes for insurers should accept these salient differences and propose solutions that differentiate accordingly.** In most jurisdictions supervisors already command a wide range of options for the monitoring and enforcement of capital and provisioning requirements for traditional insurers and they have well-established methodologies for supervising insurers in resolution. In the near future, the impact of non-insurance and non-traditional business activities in insurance groups will be analysed in more detail. If deemed necessary, the results of the analysis will be reflected in IAIS Standards relating to resolution regimes and, where appropriate, recommendations will likely be made for loss absorbency.

11. **In recent years, the IAIS has stepped forward to promote group-wide supervision.** As part of the revisions of the Insurance Core Principles (ICPs), which were first published in 2003, the IAIS has enhanced supervisory material addressing the supervision of insurers on a group-wide basis, including material relating to cooperation and coordination on both a cross-border and cross-sectoral basis as well as the treatment of unregulated entities in group-wide supervision. The revised ICPs were adopted on 1 October 2011.

12. **The IAIS has also launched work to building a common framework for the supervision of internationally active insurance groups (ComFrame).** ComFrame is directed at about 50 insurance groups that meet the criteria for internationally active insurance groups (IAIGs) as defined by the IAIS. It is designed to make group-wide supervision operational by addressing the risks these institutions are exposed to. ComFrame addresses also both the group-wide and host supervisors' perspectives by defining roles for cooperation and interaction, including the establishment of supervisory colleges.