



Insurance and the Crisis Resolution

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As the final crisis that was triggered two years ago in the subprime markets in the U.S. seems to move towards its resolution phase, the question as to what the post-crisis environment will look like is on the minds of many politicians, business leaders and experts from international institutions. A myriad of potential solutions and remedies have been put forward by many institutions in order to avoid a similar disaster in the future in global financial markets and the world economy. Most proposals for reform centre around the role of banks whose business models, processes and the behaviour of their key actors turned this crisis into the worst financial disaster since the Second World War.¹

Observers² agree that the insurance sector has not been the source of financial instability nor did its companies—as far as the insurance activity was not part of a financial conglomerate, where other businesses like financial guarantees or leveraged banking, etc. were carried out (cf. AIG or Fortis)—worsen the crisis.³ As it turned out, the insurance business model—despite some painful losses that many companies suffered in the wake of the crisis—is a very resilient one. However, insurance is part of the financial services field and a large and important investor in many markets. Any reforms of the framework under which financial services are conducted will affect the sector. It is quite understandable and logical that a crisis of the magnitude of this one will lead to sweeping changes. Anything else would be grossly negligent behaviour on the part of the architects and guardians of global financial stability. At the same time, it is very important:

- a) to specifically target the problematic elements of the arrangements that either directly lead to the crisis or that worsened its consequences; and,
- b) to avoid detrimental effects on activities that are functioning efficiently, that are not major risk factors and that do not aggravate the consequences of a crisis in a substantial way.

A shotgun approach to regulation has never been the most optimal solution to any crisis and its negative direct and indirect effects for economic performance and future growth can turn out to be substantial. As always, a balanced and informed approach is required. In its 2 April 2009 letter⁴ to the Finance Ministers of the G-20 governments, The Geneva Association outlined some areas that need to be addressed by the authorities for the appropriate organisation of the framework within which the insurance industry operates. It is important to note that the insurance sector has a strong interest in securing an effective

¹ See also the opening of the November 2008 publication of the World Bank (2008): *Weathering the Storm: Economic Policy Responses to the Financial Crisis*.

² See in particular the various publications from the insurance supervisory authorities and (on a global level) the International Association of Insurance Supervisors' (IAIS), as well as the analysis by rating agencies.

³ The kind of impact observed at some financial institutions where the core insurance business was complemented through other financial services activities or where insurance is part of other (mainly banking) financial operations has been ruinous indeed. Most prominently, AIG and Fortis reported massive losses occurring on financial products (mainly CDS and other financial guarantees) and banking activities and ultimately had to be saved through government intervention. Interestingly enough, their insurance operations have repeatedly been reported as sound by the supervisory authorities. The soundness of the insurance operations also played a key role for the structuring of the government rescue and the subsequent (expected) sale of the operations (or parts thereof).

⁴ This letter is available on The Geneva Association website under the special Credit Crisis Section together with other pertinent materials. Visit www.genevaassociation.org/Home/Credit_Crisis.aspx.

and efficient financial system. As the holder of approximately 11 per cent of world assets, it suffers directly when markets become unstable and decline.

For insurance markets to operate in a fair, efficient and sustainable manner, it is of crucial importance that governments and central banks succeed not only in fully reviving the functioning of capital markets, but that they ensure their continued stable operation long into the future. It is crucial that they introduce regulatory measures that take into account insurance's business model, and that secure incentives for sound risk and capital management maintain a level playing field—within and among related sectors.

In The Geneva Association letter, four specific areas are addressed:

1. Financial Stability and Insurance

- Restoring stability and consumer confidence remains a most critical issue to address.
- Transnational coordination is needed and an economic risk-based framework should be applied to all institutions.
- Governments need to be fully aware of the wider market impact of their interventions, which should be minimal.

2. Supervision and Regulation

- For the supervisory framework and financial regulation, the differences between insurance and other financial services providers need to be taken into account.
- The future supervisory architecture should have balanced objectives and be built on a sound foundation of national regulation.
- For the insurance sector, one of the main obstacles to international regulatory convergence is the fragmented international supervisory landscape.
- Regulatory reform must be focused, measured and considered, avoiding pro-cyclicality. Excessive capital requirements are as dangerous and inefficient as insufficient capital requirements.
- A close and continuing dialogue between governments, regulators and the insurance industry on proposals for regulatory reform is of central importance.

3. Risk Management

- The crisis has reinforced the existing importance of strong and independent risk management within insurance companies.
- An holistic view should encompass all risks and all parts of a group. In this regard integrated internal risk controls and enterprise risk management systems have to be promoted but also regularly challenged and examined.
- A risk management function independent from Profit and Loss (P&L) responsibility is essential to ensure effective internal risk governance.
- There needs to be transparency of all risks, financial and non-financial. This is particularly true for securitisation in order to revive the market.
- Sustainable Asset-Liability-Management is a core component of sound risk management in insurance and should be promoted; regulatory incentives should reinforce this.
- Risk concentrations and large counterparty risks should continue to be vigorously monitored.
- Internal models are indispensable tools for insurers and reinsurers to determine capital required and support investment and underwriting decisions. Internal models should be continuously updated to reflect changes in the risk environment and best practices. Models must be paired with sound management judgement and complemented by stress testing and scenario thinking.
- The insurance industry should put more emphasis on its monitoring of liquidity risks. Liquidity management has to be strengthened as a complement to capital adequacy.

- The experience of insurers in managing tail risks should be leveraged to other elements of the financial services sector, with special emphasis on stress tests and scenario thinking, complementing integrated risk modelling.

4. Accounting and Value Measurement

- Transparency in accounting practices is crucial and market-based valuation remains the principle that underpins financial information and management steering. It is an effective tool in delivering necessary information to investors.
- However, the limitation of accounting systems that rely entirely on market information for valuation purposes has to be recognised. In times of extreme illiquidity and distressed markets, where prices are not observable or are only randomly observable with few transactions not representing an objective value, other valuation approaches may have to be used when they better represent the economic reality.
- Keeping in mind that insurers and reinsurers hold many assets to maturity, flexible supervisory practices are therefore vital to avoid pro-cyclicality and the exacerbation of an already difficult situation.
- The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) must step up their efforts to re-examine the principles for valuing financial assets and liabilities in illiquid and distressed markets and consider different accounting mechanisms which would be more in line with other activities to adequately represent the performance, restore confidence on accounting figures, and limit volatility in the markets.

Obviously, the crisis resolution will require careful, conscientious and prudent action. It is very important that the future structures respond during both normal times and times of stress. As insurance is a long-term business that depends like few others on efficient markets, prudent risk taking by all (including governments) and the availability to diversify across regions and sectors as well as over time, it has more at stake than many other industries. As the sector has shown over the past months, it is ready to play an active role in discussions on how to frame future regulatory and supervisory structures.

A lot of the confidence in the banking sector and the financial system in general that has been lost over the past two years can only be restored if the resulting structure is efficient, fair and sustainable. The above list of points should help this process and we hope that they are taken into consideration by governments, their ministries, central banks and the institutions that guard financial stability nationally and internationally.

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