



# SC9 Insurance and Finance

Research on Finance Issues in Insurance

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## The global financial crisis and the insurance industry— Frequently Asked Questions

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### 1. Have insurers contributed to the subprime and subsequent financial crisis?

The insurance industry has not contributed to the systemic threats the global financial system has been facing following the demise of Lehman Brothers in September 2008. Insurers have **not originated and repackaged subprime mortgages**. The insurance industry **did not act as major investors in mortgage-backed financial instruments**. To the contrary, the insurance sector displayed resilience in the face of adverse market conditions and was in a position to absorb market volatility as an institutional investor with a long-term perspective. In this sense, the insurance sector acted as a **stabilising factor at a time of considerable stress** in the global financial system.

### 2. How were insurance companies impacted by the crisis?

As far as the global insurance industry is concerned four **different kinds of impact** need to be carefully distinguished: First, the direct impact of first-round effects related to credit losses on subprime mortgages; second, the impact on those financial institutions with specific exposures such as CDSs, banking operations and financial guarantee business; third, the general impact of the asset meltdown which accelerated dramatically since September 2008 and, fourth, the global economic contraction that started in 2009 and dampened demand for insurance cover from both households and the corporate sector.

Despite the fate suffered by AIG, most insurers escaped largely unscathed from the first-round effects of the subprime crisis. This is no small achievement as insurers are major players in the financial markets. Pre-crisis, in 2006, the insurance industry had US\$18.5 trillion of assets under management, or 11 per cent of global financial assets. This placed insurers only slightly behind pension funds (US\$21.6 trillion) and mutual funds (US\$19.3 trillion).

The **direct impact of the crisis on insurance was relatively limited**, not least due to the wide diversification in insurers' investment portfolios. Crisis-related write-downs by insurers total US\$233 billion (as of end 2009, cumulative since 2H 2007). These include write-downs related to credit default swaps and other derivatives, residential and commercial mortgage-related assets, corporate credit and structured products unrelated to real estate. This broad measure of crisis-related losses corresponds to roughly 9 per cent of the global (re)insurance industry's capital or 1 per cent of invested assets. In contrast, the banks have suffered total crisis-related write-downs of US\$1'251 billion, almost six times the amount recorded by insurers.

On the product side, insurers are being exposed as providers of Directors and Officers (D&O) as well as Errors and Omissions (E&O) policies. The impact, however, is expected to be relatively moderate with claims most likely not exceeding US\$10 billion.

A **second kind of impact** has been observed at financial institutions where the core insurance business was complemented through other financial services activities. Most prominently at AIG and Fortis, **significant losses occurred on financial products (mainly CDSs and other financial guarantees) and banking activities**. Their insurance operations, however, continued to perform solidly and have repeatedly been reported as sound by the supervisory authorities whose stringent controls of insurance activities had a positive effect.

The **third form of impact** relates to **realized and unrealized investment losses**. As one of the world's biggest asset managers, the insurance industry has suffered from severely falling stock market valuations and dramatically widening bond spreads during 2008 and the first quarter of 2009. The sector, however, was much less affected by the retrenchment of stocks than during the previous stock market crisis of 2001-03, which many insurers entered with equity ratios of more than 30 per cent. By 2007, as a reflection of lessons learned in the past, these ratios had come down to an average of less than 10 per cent. Since March 2009, insurers' investment portfolios and shareholders' funds have recovered strongly as fears of a financial market meltdown subsided and spreads narrowed significantly.

The **fourth kind of impact is the general economic slowdown that started in 2009**. In some lines of business, it already exerts downward pressure on insurers' top-line growth, squeezes margins, leads to additional, recession-driven claims and makes it more difficult for life insurers to meet return guarantees in an environment of historically low interest rates.

### 3. Why were insurance companies generally less affected than banks?

The major reason is that insurers, based on their fundamental business model, are **not affected in the same way by liquidity risks as other financial institutions**. They receive premiums up-front and pay out claims later. They generally **do not rely on short-term market funding** and, therefore, are not subjected to the kind of liquidity risk affecting banks. A second reason is that, following the equity market downturn earlier this decade, the insurance industry has rediscovered the crucial role of **asset-liability management** and the necessity to maintain a strong focus on **well diversified investment portfolios**. Against this backdrop, only a very small number of insurers had to ask for public support or turn to their shareholders for additional capital. They have been doing so because of their particular exposure to financial products and banking activities, i.e. **for reasons unrelated to their core insurance business**. The companies in question account for less than 5 per cent of global non-life and life premium volume. Excluding AIG whose severe losses were not incurred in the course of characteristic insurance activities, banks had to raise 20 times more capital than insurers. Another example: In the U.S., as of mid-2009, only three insurance companies had taken public support funds. In contrast, at the time, 592 banks had accessed the programme.

### 4. Post-crisis, how will the insurance industry's business model look like?

First of all, the **credit crisis has not questioned the basic business model of the industry, i.e. insurance risk underwriting**. There was no shortage of cover for life or non-life insurance at any point in time. At the beginning of 2010, capacity is even abundant, as insurance supply has recovered in line with the global financial markets, whereas insurance demand is still subdued as a result of the economic slowdown. Banks, on the contrary, have curtailed lending as they rebuild their balance-sheets and prepare for significantly higher capital requirements. In addition, they have reviewed and scaled back their securitization and their originate-to-distribute activities. Investment banking has changed, too. Traditional Wall Street firms have disappeared or morphed into universal banks.

In general, the financial crisis has encouraged insurers to **remain strictly focused on their core business of risk underwriting—a business model which has proven crisis-proof**. It is also likely to have lessened the appeal of bancassurance which has turned out particularly vulnerable to financial market dislocations and revealed major challenges in terms of organisational complexity and managerial oversight.

### 5. What is the near-term outlook for the industry?

Most importantly, there is **little likelihood of another round of substantial declines in asset values as the spectre of a global financial market meltdown has largely disappeared**. Even the drastic deterioration in the financial markets between September 2008 and March 2009 has generally fallen within the range of standard stress scenarios performed by most leading insurance companies. Earnings were adversely affected but solvency positions, in general, remained strong.

However, insurers are likely to see a **moderation in top-line growth in 2010** as a consequence of the severe recession which most economies went through in 2009. Households and the corporate sector are expected to cut back on their insurance spending. Thus, premium rates could face downward pressure as the insurance industry's capital position has strongly recovered since spring 2009, while demand remains subdued.

A continued economic recovery and mounting concerns over growing public debt burdens could lead to **higher rates of inflation and claims costs**, exercising pressure on the liabilities side of insurers' balance-sheets. On the other hand, an increase in interest rates would provide relief to those life insurers who have issued return guarantees which are difficult to meet in an environment of historically low interest rates.

### 6. Should insurers be more rigorously regulated?

First of all, as far as core insurance activities are concerned, **regulation has generally proven adequate and effective**. However, this was not always the case for financial conglomerates or holding structures, where sizeable insurance operations were (and still are) submitted to top-level oversight by non-insurance bodies. How to regulate and supervise financial conglomerates remains a key concern. In addition, there are gaps between supervisory activities in different parts of the financial sector, especially where international operations are concerned. These gaps will have to be closed and activities among national supervisors need to be coordinated more closely. The current mismatch between domestically-focused regulation and supervision on the one hand, and the reality of cross-border insurance operations on the other, needs to be addressed.

In addition, the **Solvency II reform in Europe**—which is having an international impact as reference model for many other countries and their reform activities—already addresses several weaknesses of the current regulatory framework in Europe and **should further shock-proof the industry**.

In light of the current unprecedented level of regulatory activity in financial services, the insurance industry faces the **danger of collateral damage** if regulation is based on the inaccurate assumption that **banks and insurers** are offering similar services and pose similar threats to financial stability. As a matter of fact, the nature of the services provided, the **underlying business models** and the risks associated with them, **differ considerably**. For example, insurers' exposure to liquidity risk is low as they receive premiums up-front and pay claims later. Also, they are not highly leveraged and less interconnected with the financial services industry. Finally, insurers pose little systemic risks as regulators can intervene early on in the event that an insurer encounters financial difficulties and generally have more time to sort out any potential problems. Furthermore, as history has shown, competitors usually step in with capacity and services in the event of an insurer's failure.

Therefore, there is no need to impose overly prudent capital requirements on insurers, a move which would ultimately—and totally unnecessarily—drive up the cost of insurance to policy-holders, possibly restricting access to certain insurance products and hampering future growth. Against this backdrop of arguments, the industry is resisting current attempts to impose higher capital requirements across-the-board, not taking into account specific risk characteristics. The insurance industry has

successfully passed the real-life stress test of arguably the most severe financial crisis since the Great Depression almost 80 years ago. There were no signs of systemic instability in the insurance sector. Capital levels have proven adequate. Therefore, any regulatory reforms focusing on capital requirements would be misguided. Most importantly, Solvency II must not be diluted by crude ratios as mulled by banking regulators.

#### 7. Which lessons has the industry drawn from the financial crisis?

Most insurers will probably conclude that their corporate strategies should **remain firmly focused on core competencies in risk underwriting and avoid unfamiliar areas such as complex financial products.**

Insurers will also be encouraged to pursue or continue with **conservative investment strategies** which also take into account hitherto underestimated liquidity risks, i.e. the possibility of markets drying up and any meaningful valuation becoming impossible.

And, finally, insurers clearly recognise the need to continue to strengthen their internal risk governance to respond to changing market conditions.

#### 8. How can insurers restore policy-holders' trust?

So far, **no insurance company has defaulted on its obligations vis-à-vis policy-holders.** Only a small number of large insurance companies have experienced significant calamities arising from non-core operations. However, insurers are affected by the fact that the financial services industry at large is under **enormous public pressure and scrutiny, given the massive scale of banking bail-outs and controversy around compensation policies.**

In this environment, **open, transparent and honest communication** is a necessary condition for restoring trust. Such efforts, however, need to be accompanied by **superior performance meeting customers' expectations:** Transparent and competitive rates, flexible terms and conditions, timely claims payments, continuous product innovation, to name the most important performance elements.

#### 9. How can insurers contribute to a sustainable economic recovery?

The most effective contribution is to continue to perform **the industry's key role in a modern economy:**

- (1) **promote financial stability and security** at both the national and personal levels;
- (2) **encourage productive investments and innovation** through the mitigation of the consequences of financial misfortune;
- (3) **mobilise savings;** and
- (4) contribute to an efficient use of capital -based on insurers' **role as significant institutional investors.**

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