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Insurance and Finance

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Credit Crisis and Insurance – A Comment on the Role of the Industry

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This article was published on The Geneva Association's website on 14 November 2008

At the time of writing this article, the credit crisis that has had its origins in the subprime markets in the US is more than a year old and has spread to other countries and other asset classes as well as the wider economy with a vengeance. Already last year, when some banks and financial guarantors began running into severe (and in some cases ultimately bankruptcy-triggering) shortages of liquidity, The Geneva Association wondered about the risks that this financial crisis might pose to the insurance industry.

In January 2008, we started to discuss the issue with our members and several Geneva Association expert networks, among them our Amsterdam Circle of Chief Economists. In the process, a dedicated working group of chief economists from some leading international insurance companies set out to analyse the crisis and carry out joint work that would provide special insights into the nature of the credit crisis and its consequences for insurance.

At the centre of the endeavours of this working group are the following sets of questions:

- What happened in the financial markets? What were the origins of the crisis, what were its triggers and possible reinforcing elements? How did subsequent events develop?
- To what extent was and is the insurance industry affected? How do overall losses compare to the losses of the insurance sector? How should the crisis be interpreted from an insurance point of view? Is there a systematic threat to the insurance industry? Is there a systematic threat emanating from the insurance industry?
- What are the conclusions for the insurance sector? Are there (already) some lessons to be learned? What is the impact on regulatory debates (solvency reforms, IFRS proposals, etc.)? How are newer business trends like securitisation of insurance risks affected?

Even though already more than a year has passed since the first troubles started back in August 2007, we still cannot say whether the crisis is coming to an end soon. In addition, ever new and unexpected developments linked to the crisis are driving it so quickly that the original idea of producing a printed report has been postponed in favour of a more reactive and faster approach. This new approach sees the channelling of a diverse set of materials, many of them either directly linked to The Geneva Association's efforts or based on work at member companies and partnering institutions. The Geneva Association website is making this material available to everybody who has an interest in understanding the credit crisis from an insurance point of view.

Although a number of the questions raised above shall be discussed here in a brief way, at this stage of the crisis it is not easy to draw conclusions. This is due to the fact that the end of the crisis has not yet fully materialised, that the impact of the recession in many countries is unknown and that further rounds of corrections are possible. What makes the analysis of the consequences of this particular crisis so demanding and complex is the fact that it is composed of three different elements:

- Firstly, the original liquidity problems that so much affected the banking sector and which provoked an acute systemic threat;
- Secondly, the impact of expected credit losses from subprime mortgages on those financial institutions with specific exposures such as CDSs (credit derivative swaps), MBS (mortgage back securities) and similar; and
- Thirdly, the general impact of the asset meltdown which accelerated dramatically since September 2008.

The effects of a world economy in recession are very distinct from the impact that the original credit crisis has had on insurance. While the global credit crisis has already created great problems for some parts of the financial services industry, most insurers have escaped the first two adverse developments (liquidity dry-up and credit losses from subprime mortgages) largely unscathed even though they are major players in the financial markets. This is no small achievement. In 2006, the insurance industry had USD 18.5 trillion of assets under management, or 11% of global financial assets. This placed insurers only slightly behind pension funds (USD 21.6 trillion) and mutual funds (USD 19.3 trillion).

While interbank lending for a short time (and until government and central bank action kicked in) came almost to a halt in some regions, like the EU, the insurance industry continued to do business. While banks and many other financial institutions did not trust their peers anymore and hence restricted counterparty interaction to a minimum, the insurance industry continued to share risks on a normal level. We have so far not learned of any major impairment in the ability of insurance companies to obtain reinsurance or problems between reinsurers and their retrocessioners. Whereas many businesses have been complaining over the past weeks that their access to bank liquidity was severely impaired (as has been their access to financial guarantors, including the misleadingly called credit “insurers”, i.e. financial guarantors who secure credit positions) and that lending did not take place as they would need it to continue their operations (leading to specific government action in the US, Europe and other parts of the world), no wave of complaints as to the functioning of real insurance markets has appeared. Insurance companies and their clients have been able to organise the transfer of risks in an orderly fashion and emergency government action was not needed. This is important to note as it shows how distinct the insurance business is from banking and the provision of other financial services.

In this respect it is important to distinguish three different kinds of financial institutions: banks (retail and investment) on the one hand and (traditional) insurance and reinsurance companies on the other, with a third group, large complex financial institutions, falling in between. While insurers operating in traditional ways have escaped the adverse effects as described above, this cannot be said of all large complex financial institutions that conduct insurance. 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 whose stringent controls of insurance activities apparently lead to more careful risk management by the insurance operators within those institutions. In the case of AIG, the ability to service the government debts and the losses incurred by the business unit that conducted financial guarantee business, depends heavily on the soundness and continued operation of the insurance part of the company.

In short, the main reason for this remarkable resistance of the insurance operators to the first two threats has been a combination of the resilience of the insurance business model when it comes to liquidity constraints and prudence by most operators following past experiences. The already tight supervision of insurance operations certainly played a positive role too.

However, this does not mean that insurance companies are able to escape generally negative developments of major asset classes (which are going down in value because of new risk assessment, a deteriorating economic climate and a generally less optimistic growth outlook, rather than just liquidity issues). After all, insurers have large balance sheets and hold a sizeable amount of diverse assets.

If the world economy or some relevant parts of it were to fall into a prolonged and deep recession (rather than a shorter and more limited contraction) then the consequences for insurance and indeed the economy in general could be dire indeed. A protracted and profound recession poses a different set of challenges, not only to insurance but to all economic actors. We can only hold our breath at this time, hoping that the world will escape a major downturn lasting for many quarters. Already the severe asset meltdown that has occurred to date has affected the insurance industry as holder and guardian of important and diverse investments in a very negative way. With every new wave of distress, the solvency positions of more players will be tested. So far they have held up remarkably well.

What is interesting to note, however, is the limited involvement of the insurance sector in the credit crisis itself. The handful of companies that have suffered badly as a consequence of the credit crisis are mostly those that had special operations as financial guarantors. In this sense they did not operate as insurance companies but as owners of and investors in a different type of business. This is where regulators and supervisors should be alert in the future: insurance companies branching out into risky ventures or other riskier players (such as banks or financial guarantors) moving into insurance, creating possible transmission mechanisms previously unnoticed.

Insurers have not been submitted to the same systemic issues that many banks are facing today. Nor have they contributed to global financial instability. On the contrary, the insurance industry displayed resilience in the face of adverse market conditions (liquidity squeeze) and was in a position to absorb market volatility, thus acting as a stabilising factor at a time of considerable stress in the global financial system. It is important to note that the credit crisis does not question the business model of insurers. There is no shortage of cover for life or non-life insurance. Capacity appears to be ample and, with the exception of D&O and E&O insurance, prices in most lines of business continue to be under downward rather than upward pressure.

Regardless of how a recession scenario might play out and what other negative developments might still occur, there is one important lesson to be drawn from the credit crisis so far that has not received enough attention, namely that insurers are markedly different from banks and that their distinct business models expose them to lesser risks in the liquidity domain. In fact the nature of the services rendered by banks and insurers, the underlying business models and the risks associated with them, differ considerably. This must be reflected in different regulation and capital requirements for both industries in the future. "*Insurers are not banks*" is a simple statement but with far-reaching consequences for the economic system and policy-making.