

Dedicated insurers are not a systemic risk

An assessment after the first year of the global credit crisis

by Daniel M. Hofmann and Axel P. Lehmann

With the exception of American International Group, insurance companies until now have not suffered any life-threatening blows as a result of the global credit crisis. The authors of the following article warn against lumping banks and insurance companies together. They are also of the opinion that the insurance industry has had a stabilizing influence on the financial system in recent times thanks to its anti-cyclical investment behavior.

Since the US government came to the rescue of American International Group (AIG), the question has arisen as to whether insurers too constitute systemic risk. However, an objective analysis reveals that there are essential differences between the business models of insurance companies and banks. These differences also need to be considered by regulatory and supervisory authorities.

While in the first year of the credit crisis it has been primarily investment banks that have been deemed to constitute systemic risk, the situation appears to have changed with the case of AIG. The US Treasury would hardly have stepped in if the imminent collapse of one of the world's largest insurance and financial services groups had not threatened to drag down other institutions – including some outside the USA. Nevertheless, it would be wrong to draw the conclusion that insurers constitute systemic risk in the same manner as banks do. The core business of AIG is considered healthy and the insurance company appears to be solvent. The systemic risk was rather attributable to the fact that AIG is a large, complex financial institution that offered financial derivatives, which had nothing to do with the actual business of insurance.

Minimal liquidity and stability risks

Consequently, insurers hardly constitute systemic risk. This statement can be substantiated with reference to the business models of banks and insurance companies, where major differences can indeed be found. While banks are always exposed to the risk that customer withdrawals can exceed available liquidity, the risk of a liquidity shortfall is minimal for insurance companies.

One main reason for this is the difference in financing models. Insurance companies are essentially financed by premiums paid in advance and payments are subject to the occurrence of insured events. Such payments are generally unaffected by other insured events. As long as the insurance company has built up reserves and investments are calibrated to match the statistically anticipated claims payments, there is no liquidity risk. Furthermore, insurance companies do not use leverage to enhance expected investment returns, a fact that makes them less vulnerable when financial markets collapse. For these reasons alone, the banking system's perennial moral hazard of being "too big to fail" has no equivalent in the insurance industry.

The differences also include the fact that many insurance companies have not been forced to dump assets in order to maintain solvency. This is in contrast to the events after 2000 following the bursting of the dot-com bubble. Insurers have obviously learned some lessons and reduced the proportion of equities in their investment portfolios from levels deemed previously to be too high. In this way, insurers may actually have dampened market swings in recent months and thus stabilized the global financial markets overall.

What's left of convergence?

Now that AIG has become a systemic risk in its role as a major financial service provider and not as an insurer, the sustainability of the convergence of capital and insurance markets has become an issue. In recent years insurance companies have actually stepped up their capital market activities by offering insurance-linked securities. However, unlike in the banking industry, insurance securitization has remained firmly anchored within the scope of risk and capital management. Catastrophe bonds, to cite the best-known product, tend to cover only peak losses. Because part of the risk remains on the insurance company's balance sheet, the securities are attractive to investors. Consequently, it is not surprising that they have successfully withstood the acid test applied by the credit crisis, in contrast to other financial products. The significance of insurance-linked securities will undoubtedly increase over time.

The answer is likely to be different when we ask whether individual insurance companies will continue to offer financial derivatives such as Credit Default Swaps (CDS). This is a tricky issue because a CDS looks like an insurance transaction. Buyers pay premiums and receive compensation when a loss (a company default) occurs. But as financial derivative, a CDS does not constitute insurance and it violates also important technical underwriting requirements that would make it an insurance product. The recent events should have made it clear that CDS and transactions involving financial guarantees are not necessarily part of an insurer's core competency. Hence, it remains to be seen whether the convergence of insurance and capital markets will continue to progress on this course.

Need for supervisory differentiation

The business landscape is now dominated by huge, global financial services corporations. In recent years, many central banks and the International Monetary Fund have dedicated in their stability reports considerable space to Large Complex Financial Institutions (LCFI). Nevertheless, many transactions have remained under the radar screen of supervisors, with some LCFI having even become systemic risks. But while the problems have surfaced, many issues are still to be resolved. Who is responsible for monitoring LCFI? Is it an integrated supervisory authority with global jurisdiction? What happens in the case of instruments (such as CDS) that have yet to be regulated? And who is to be the "lender of last resort" in the event of a crisis?

While the discussion on these matters will continue for some time, it is already obvious that insurance companies and banks should not be lumped together in one basket. Their operating models are too different. Banks and insurance companies should be treated the same where they use the same instruments with the same risks. But different risks must be treated differently also in future.

Insurance companies are not banks and banks are not insurance companies. Anyone who ignores this fails to appreciate the economic role of insurance companies and ultimately impairs the performance of the entire financial industry.

Comparatively good showing

DMH/APL. More than the USD 700 billion in financial assets have been wiped out since the outbreak of the credit crisis. The lion's share, or roughly USD 520 billion, involves banks. In contrast, insurers have come away comparatively unscathed, although they constitute some of the largest investors in the global financial marketplace. When considering insurance companies, it is important to differentiate between the product and investment sides. At around USD 160 billion (at the end of the second quarter), half of the write-downs fell on products offered by specialized insurers (above all the 'monoliners' in the USA) and structured products (such as CDS). This leaves USD 80 billion for writedowns on capital investments, corresponding to less than 0.5% of the USD 18.5 trillion in assets invested by insurance companies. In comparison, global insurers had to bear more than USD 100 billion in natural catastrophe losses in 2005.

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