



# No Systemic Risk from Insurance Core Activities

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Findings of The Geneva Association Special Report  
on Systemic Risk in Insurance

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London

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## Setting the Scene

*Nikolaus vom Bomhard*

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## Insurance industry contributes constructively to the debate on systemic risk

### The insurance industry and the systemic risk discussion

- The Geneva Association welcomes you to the presentation of the report “Systemic Risk in Insurance – an analysis of insurance and financial stability”
- This report is an industry response to the ongoing discussion by policy-makers and the media on potential systemic risk posed by insurance companies; the G-20 Summit in Pittsburgh last fall has initiated these discussions on systemic risk

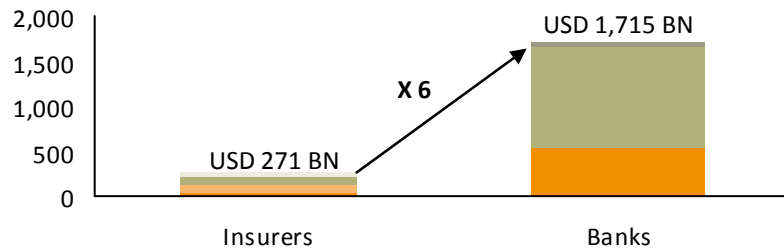
### Purpose of the report

- The industry would like to provide policy-makers and the public with its view on systemic risk
- With this report, the industry provides a new and insurance-specific perspective on systemic risk and wants to contribute constructively to the ongoing debate
- The industry makes a contribution to identifying potential systemic risk drivers and puts forward some recommendations on how to deal with them
- The insurance industry wants to ensure the stability of the financial system by pro-actively engaging in the ongoing debate on systemic risk

# Insurers went through the crisis relatively unharmed and business was conducted as usual

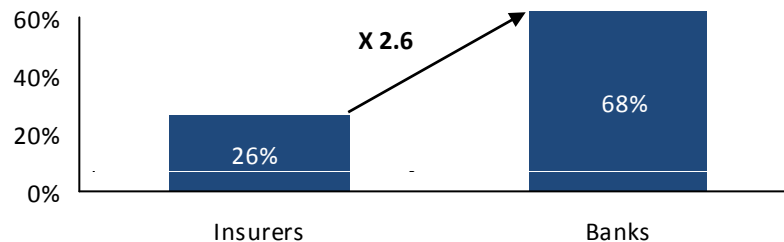
## Credit losses

Cumulative from 2007 (USD BN)



## Credit losses

Cumulative from 2007, as % of 2006 Shareholders Equity



## Non-Life Insurance price changes in Europe (% from previous year)

### Casualty (example)

	Q1 & Q2 2007	Q1 & Q2 2008	Q1 & Q2 2009
France	10-20	10-20	0
Germany	10-20	10-20	0-10
UK	10-20	10-20	0-10
Italy	0	0-10	0
Spain	10-20	10-20	20-30

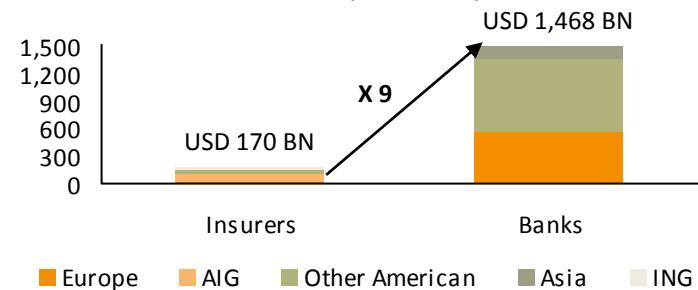
X% Decrease

Flat

X% Increase

## Total capital raised

Cumulative from 2007 (USD BN)

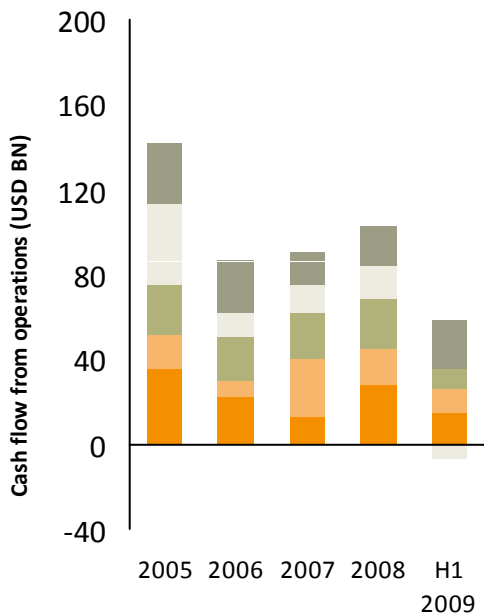


Lower credit losses for insurers ...

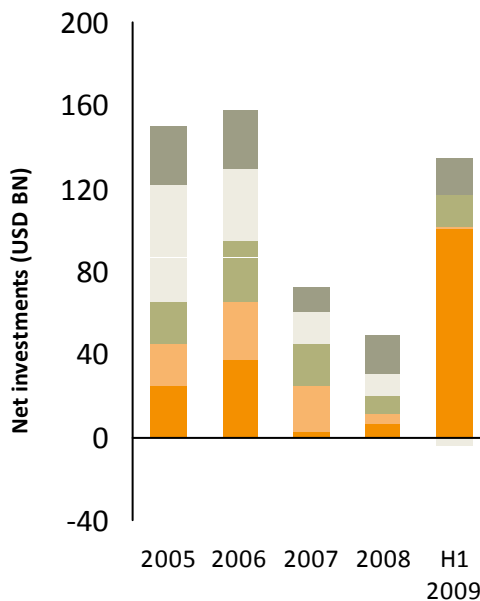
... meant stable prices and capacity for customers and much less bail out capital

# This strength came from strong positive cash flows, long-term investment policies and a stable customer base

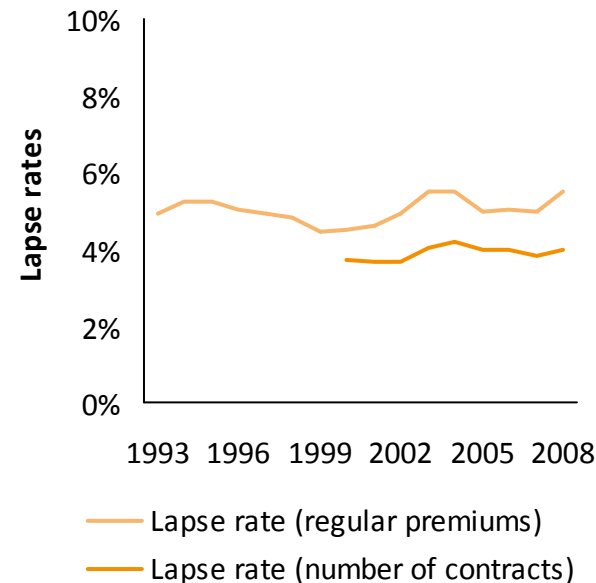
**Net cash flows from operations**  
Top 5 European insurers<sup>1</sup>



**Net investments**  
Top 5 European insurers<sup>1</sup>



**Lapse rates – Example German Life**



Legend: Allianz (orange), Aviva (light orange), Axa (green), ING Group (light grey), Generali (dark grey)

**Strong cash flows**

**Long-term, liability-driven investment**

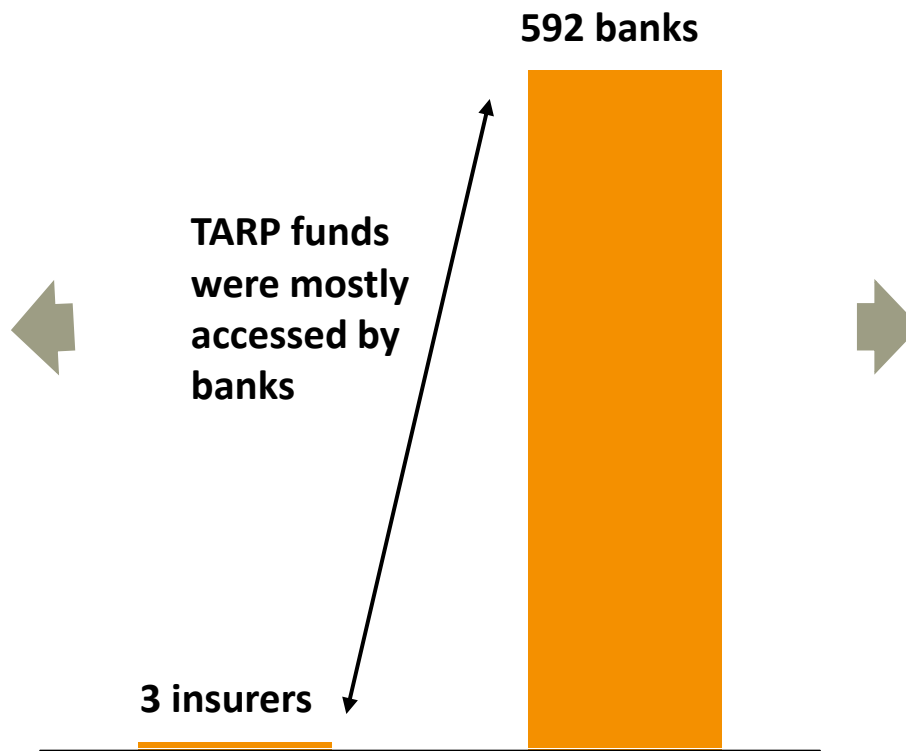
**No experience of “runs” on insurers**

Source: Annual Reports, GDV, Oliver Wyman analysis  
1: Top 5 insurers by assets at 31.12.2006 in USD terms

# The relative stability of the industry is also illustrated by the fact that far fewer insurers needed State support to survive the crisis

Number of insurers and banks that had taken TARP funding in the U.S. by mid June 2009

TARP funding only	
Insurer	USD BN
AIG	40
Hartford	3
Lincoln	1
<b>TOTAL</b>	<b>44</b>



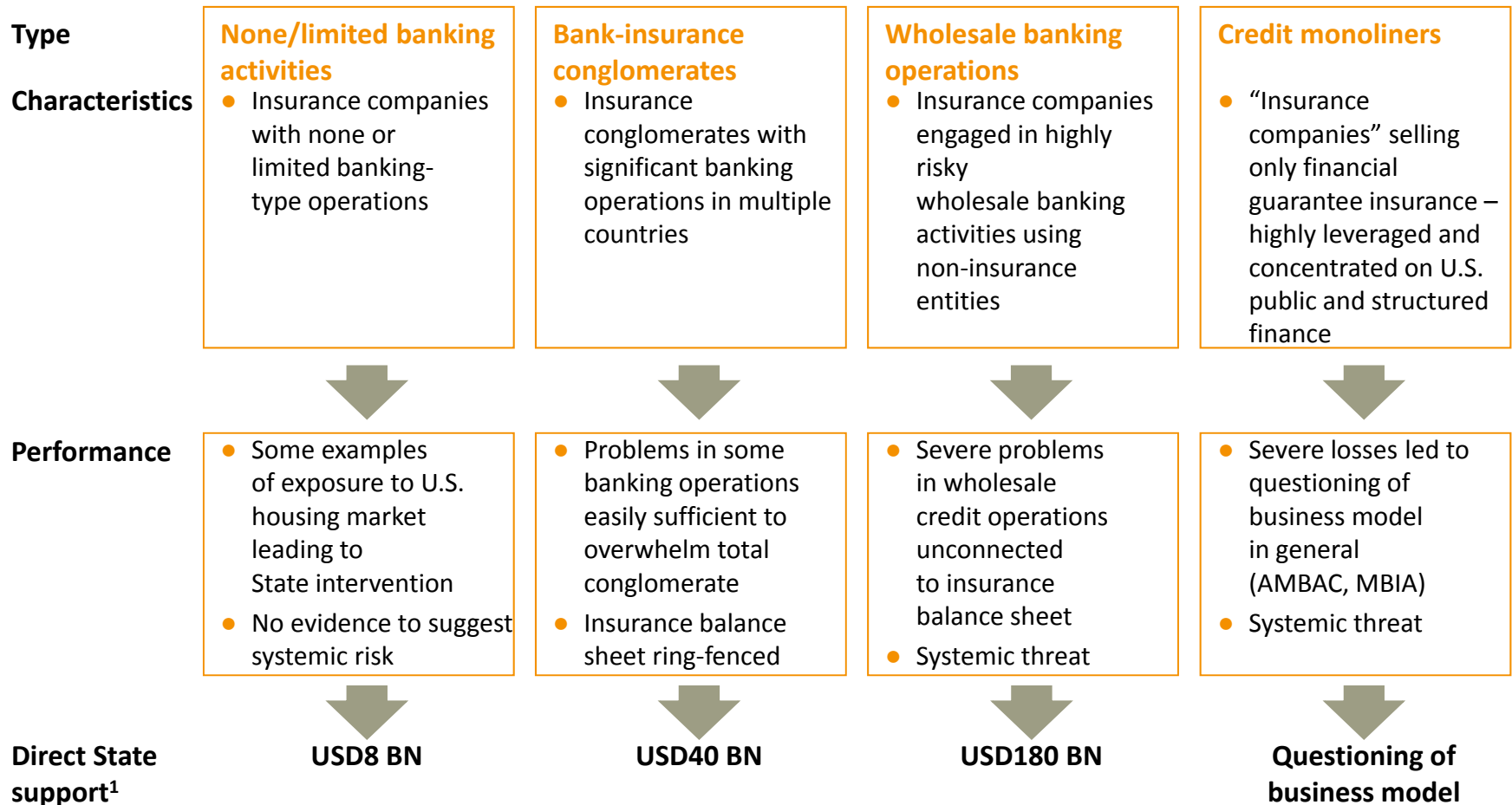
TARP funding only	
Bank	USD BN
Citigroup	50
BoA <sup>1</sup>	35
JPM <sup>1</sup>	25
Others	135
<b>TOTAL</b>	<b>245</b>

Source: US Treasury

1. BoA: Bank of America; JPM: JPMorgan Chase

# However, some insurers did hit problems, especially where they had large banking or credit operations

## Size and risk of banking operations within insurance companies triggered insurers' performance



1: State support reflects capital injections and asset support provided by States. Exchange rates as of 31.12.2008  
Source: Bloomberg, Company Reports, Oliver Wyman press search, Oliver Wyman analysis



# FSB and IAIS definition of systemic risk

*Andrew Moss*

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## The report uses the FSB definition and criteria for identifying systemic risk as supplemented by the IAIS

### Definition of Systemic Risk (FSB)

- “The risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.”
- Fundamental to this definition is the notion that systemic risk is associated with negative externalities and/or market failure and that a financial institution’s failure or malfunction may impair the operation of the financial system and/or the real economy.

### Identification of systemically relevant institutions

#### FSB criteria

- **Size:** “The volume of financial services provided by the individual component of the financial system”
- **Interconnectedness:** “Linkages with other components of the system”
- **Substitutability:** “The extent to which other components of the system can provide the same services in the event of a failure”

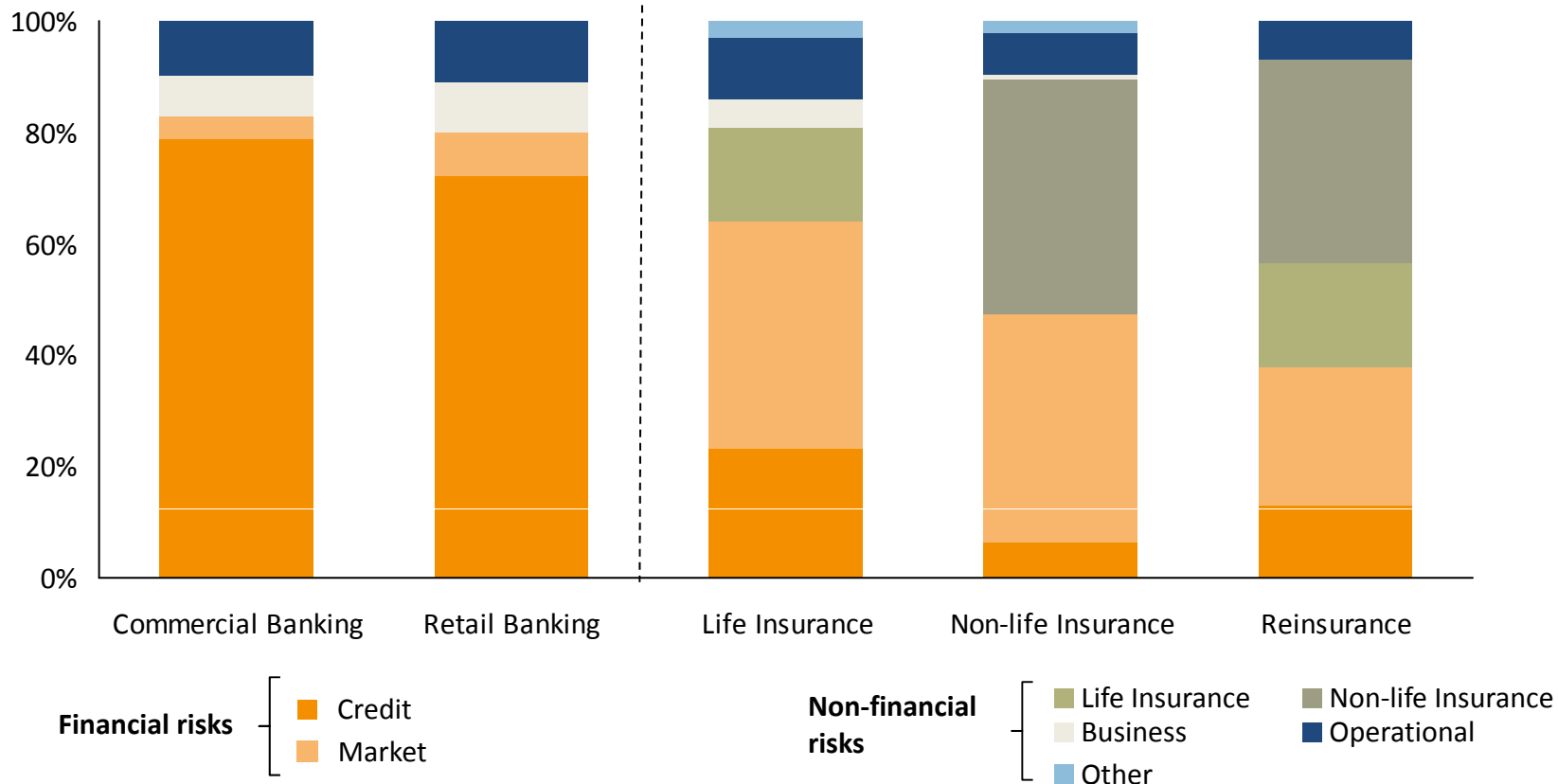
#### IAIS addition

- **Timing:** Allowing for the fact that systemic insurance risk does not typically generate immediate shock effects, but plays out over a longer time horizon

**The impact of the definition and criteria varies depending on the range of activities carried out by institutions such as banks and insurers**

# The application of FSB criteria and IAIS addition needs to take account of the business activity of an institution to determine systemic risk (1/4)

## Breakdown of economic capital for European banks and insurers

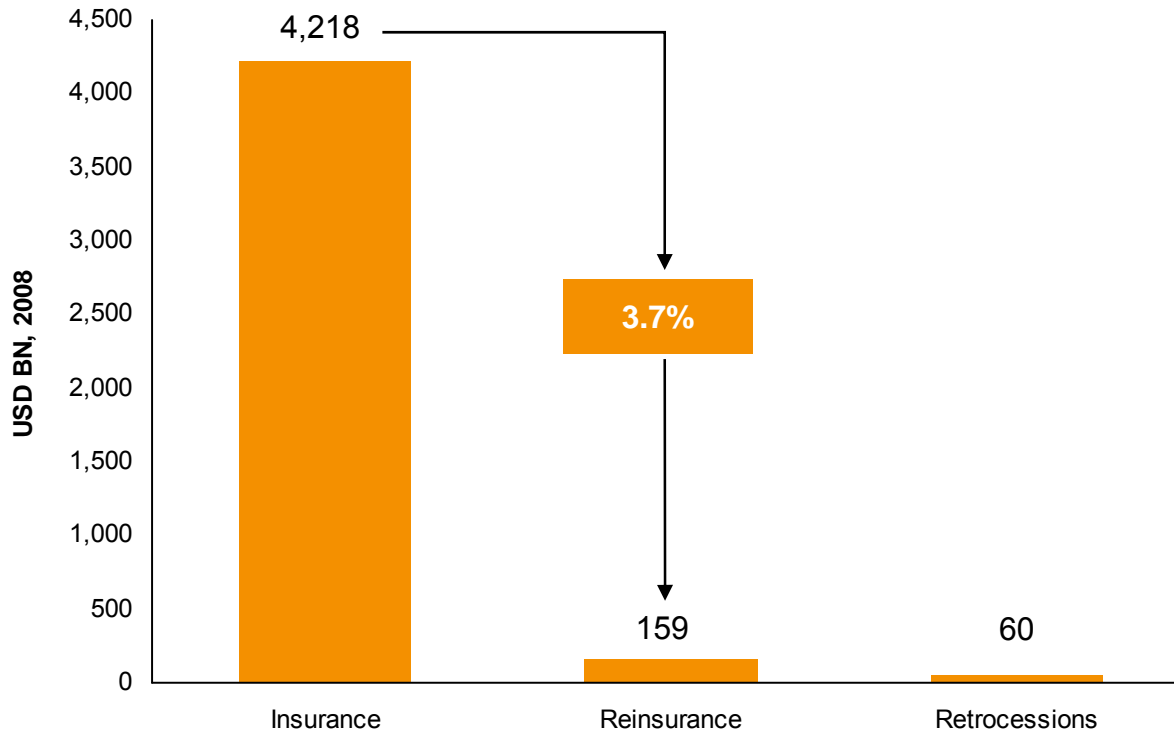


**Diversification not size is key**

Source: 2006 ECAP Survey, – IFRI CRO Summary, prepared by Oliver Wyman – Companies’ Annual Reports

# The application of FSB criteria and IAIS addition needs to take account of the business activity of an institution to determine systemic risk (2/4)

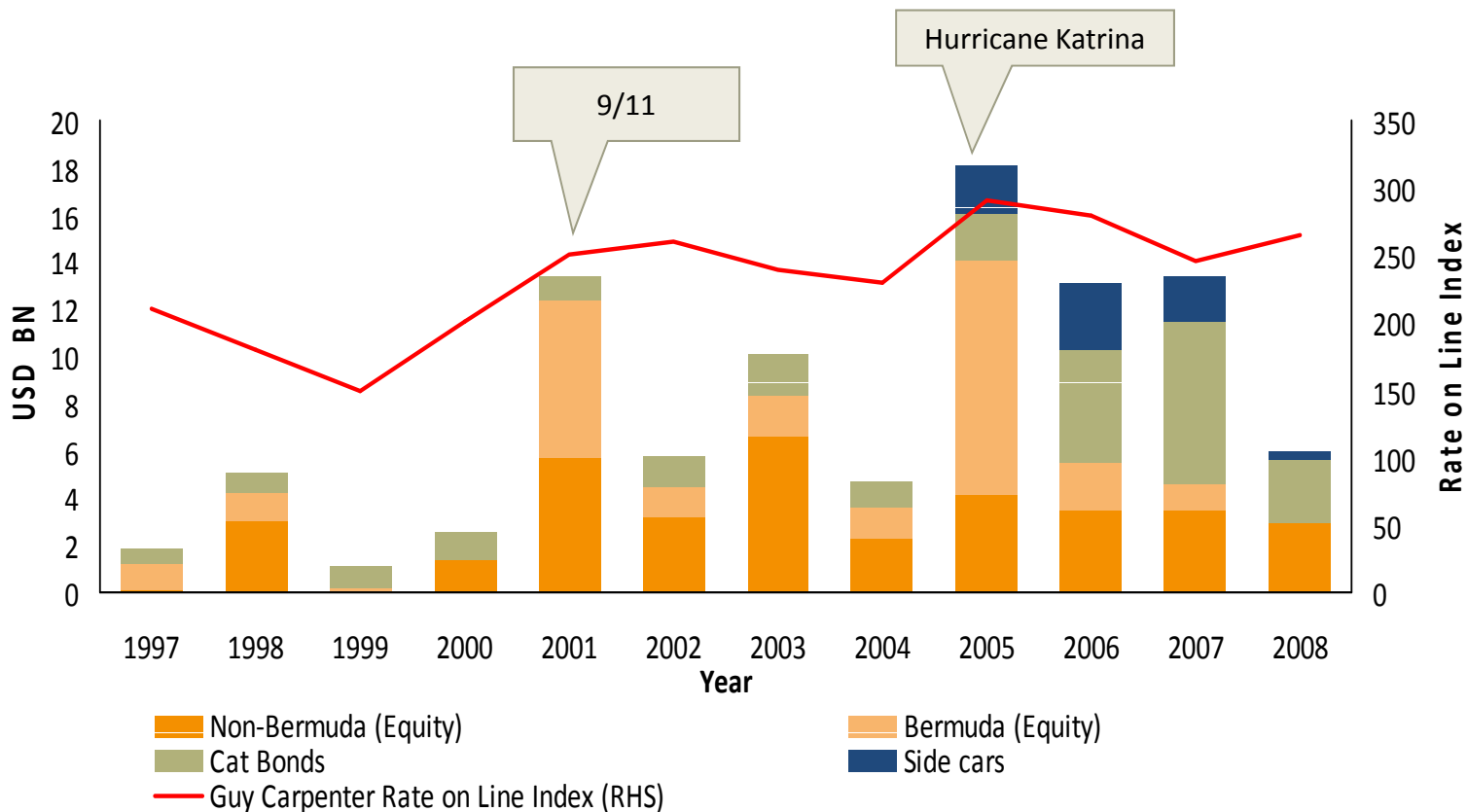
Low level of business ceded by insurers, based on gross written premiums, USD 2008



**Low interconnectedness**

# The application of FSB criteria and IAIS addition needs to take account of the business activity of an institution to determine systemic risk (3/4)

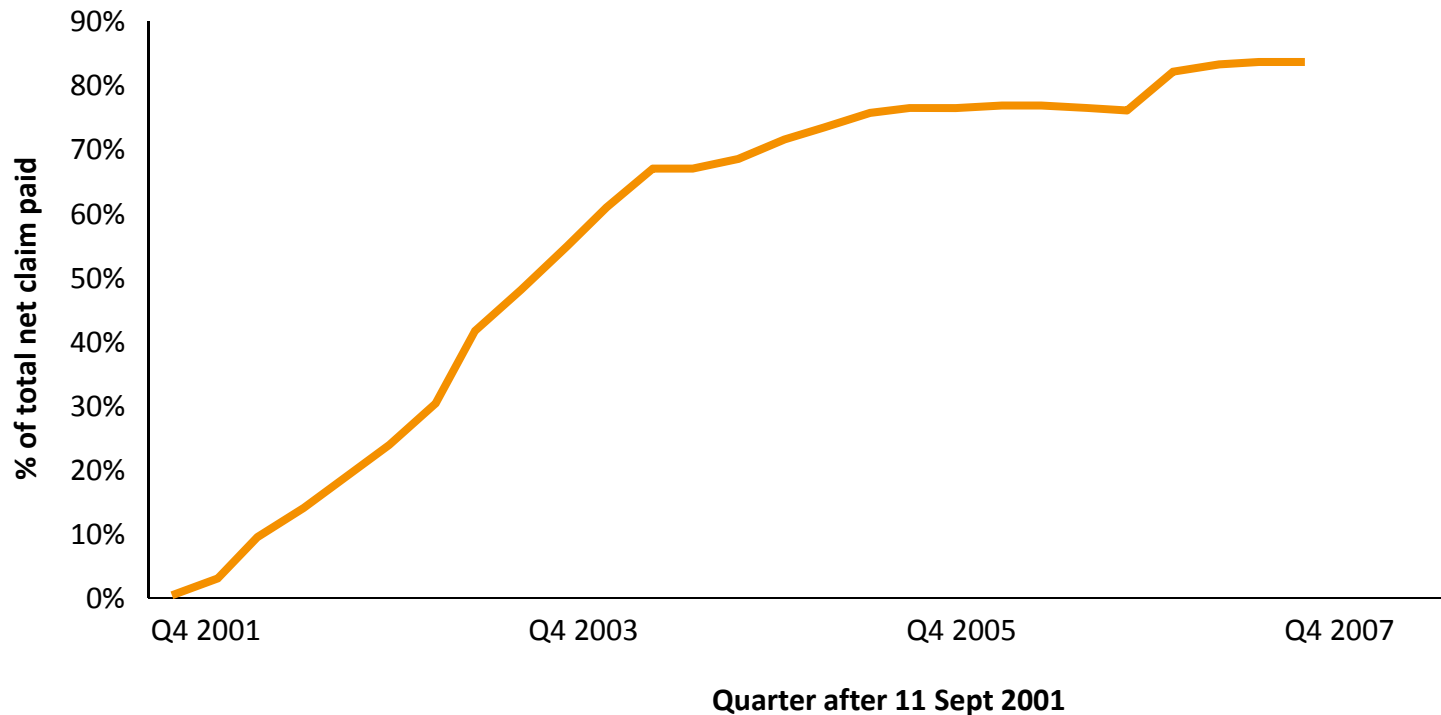
## New capital flows into nat cat reinsurance industry and nat cat reinsurance rates



**Highly substitutable**

# The application of FSB criteria and IAIS addition needs to take account of the business activity of an institution to determine systemic risk (4/4)

## Timing of World Trade Centre Insurance Claims Cumulative proportion of claims made



### Gradual cash flows

## In conclusion...

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**!** Size needs to distinguish between absolute concentration of exposure or dilution of risk through diversification

**!** Interconnectedness needs to allow for the materiality of the connections compared to the overall balance sheet

**!** Substitutability needs to distinguish between the uniqueness of any individual market participant, and the ability of a market as a whole to be re-capitalised

**!** Timing of transmission between insurers is significantly slower than between banks, allowing mitigation measures that dampen systemic risk

**Thus, we argue that the criteria need to be considered against specific risk activities, rather than institutions**



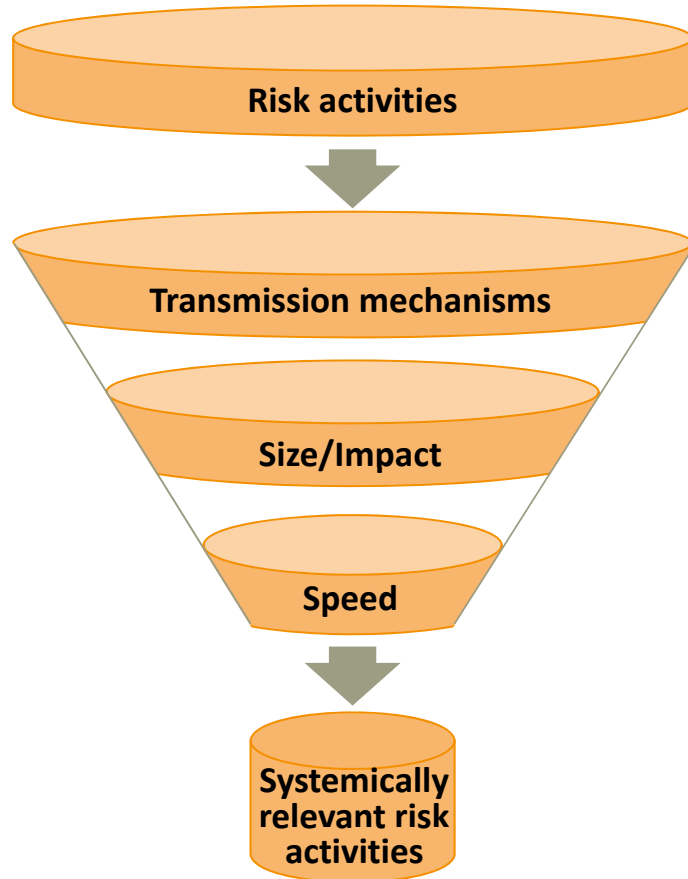
# Assessing the systemic relevance of insurers' risk activities

*Stefan Lippe*

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# Approach for assessing systemic relevance of risk activities

## Criteria considered for assessing the systemic relevance of risk activity



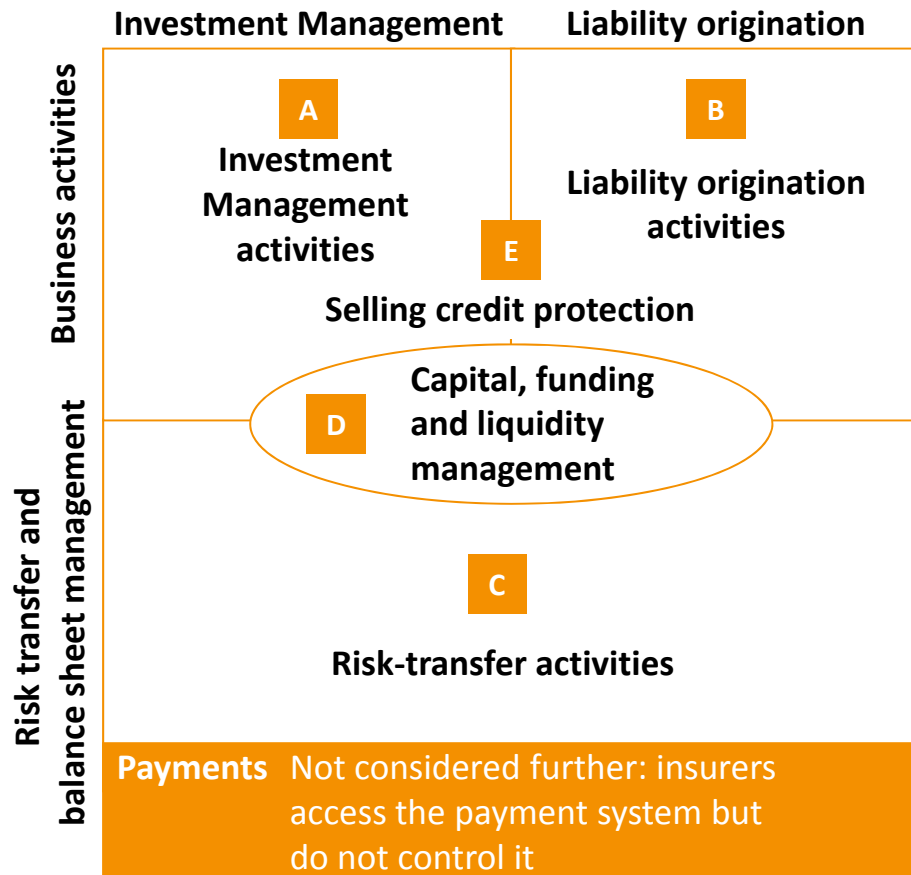
## Specific considerations when assessing the criteria

- Does a transmission mechanism exist?
- What are the triggers?
- What is the likelihood of these triggers being breached?
- Can the risk activity cause significant losses?
- Can the activity be substituted by someone else?
- How big is a potential impact?
- How fast does the loss materialise?
- How fast does the loss transmit?

**Risk activities are deemed systemically relevant if they pass the risk assessment**

# We apply the FSB criteria to the universe of activities potentially carried out by insurance companies

## Overview



## Key activities in which insurers are engaged

- A** Investing policy-holders' and shareholders' investments, in equities or derivatives
  - ALM and strategic asset allocation
  - Derivatives activities on non-insurance balance sheets
- B** Traditional insurance business of originating liabilities by providing protection/guarantees
  - Underwriting catastrophe risks
  - Underwriting long term risks
  - Writing business with redemption options
  - Writing life business with embedded guarantees
- C** Transferring insurance and market risks to third parties
  - Hedging with derivatives
  - Reinsurance and retrocession
  - Insurance linked securities and derivatives
- D** Capital raising, short-term and long-term funding, liquidity management
  - Treasury related-activities
  - Long-term capital raising
- E** Selling credit protection
  - Credit insurance
  - Financial Guarantees<sup>1</sup>
  - CDS writing (on large scale and off balance-sheet)

## Specific business model

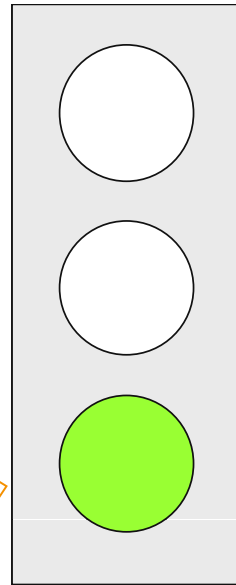
- Financial Guarantees<sup>1</sup>

<sup>1</sup> Not considered to be part of "usual" insurers' universe of activities as provided by monoliners  
Source: Oliver Wyman Assessment

# Insurers core-activities are not systemically relevant as their size, interconnectedness, substitutability and timing would not create immediate impact on financial stability

## Risk activities not deemed systemically relevant

- A**
  - Asset Liability Management & Strategic Asset Allocation
  - Underwriting catastrophe risks
  - Underwriting long-term risks
- B**
  - Writing business with redemption options
  - Writing life business with embedded guarantees
- C**
  - Hedging with derivatives
  - Reinsurance and retrocession
  - Insurance linked securities and derivatives
- D**
  - Long-term capital raising
- E**
  - Credit insurance



## Systemic relevance rejected for at least one of the following reasons

- ✗ Size:** Limited size
  - No disruptive effects on financial markets
- ✗ Interconnectedness**
  - Level / intensity of interaction does not create contagion
- ✗ Substitutability**
  - Given ability of market to find a substitute
- ✗ Timing:** Slow speed of impact
  - Allows insurers to absorb impact, through capital raising or orderly wind-up

## No core insurance activities are systemically relevant - just two non-core activities that could be systemically relevant

*Core insurance/ reinsurance business do NOT represent a risk to the financial stability...*

*... however, some risk activities, IF conducted massively under inadequate risk control and poor supervisory oversight, could be of systemic relevance to the wider financial sector*



- **Derivatives trading on non-insurance balance sheet (including CDS trading)**



- **Mis-management of short-term funding raised through commercial papers or securities lending**



# Mitigating measures

## *Nikolaus von Bomhard*

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## Regulation that would only be applied to a few 'too big to fail' insurers likely to distort entire insurance market and impact the broader economy

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- Following adverse consequences could occur:
  - **Market unfairness** and need to re-state each year creating unfair follow-on issues
  - **Increased pricing** by systemic institutions, while non-systemic players price aggressively
  - **Decrease in risk-bearing capacity:** likely to increase overall pricing (unless additional capital is raised)
  - **Moral Hazard:** perception of 'too big too fail' across competitors, investors and clients that they have 'de-facto state guarantee'
  - **Distraction of regulators attention** from risk activities or products triggering systemic risk
- Broad economic consequences given (re-)insurers macro-economic role regarding provision of savings- and risk transfer products

- **To tackle the issue of systemic risk, supervisors and policy-makers need to identify systemically risky activities**
- **Potentially systemically relevant activities should be dealt with through a responsive regulatory framework**

## Current and planned regulatory regimes in Europe and the U.S. adequately capture insurance activities. However, two risks need to be addressed further

### Regulation of assessed main insurance risk activities (European and U.S. insurance regulation)

- The assessed regulatory regimes address the discussed risk activities
- However, comprehensive and integrated regulation needs to be assured across all geographies in order to appropriately capture all risk activities
- The two non-core insurance activities require specific regulatory elements to ensure proper regulation which are briefly summarised below and detailed in the recommendations

### Derivatives activity on non-insurance balance sheets

- Comprehensive, integrated and principles-based supervision of insurance groups
- Group-wide and tailored capital requirements

### Mis-management of short-term funding raised through commercial papers or securities lending

- Group-wide liquidity risk management, e.g.:
  - Liquidity stress tests
  - Strong liquidity risk governance

**In our mitigating measures, these risk activities are adequately addressed**

## **We recommend five measures that demonstrate the industry's engagement to contribute constructively to the discussion on systemic risk**

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### **Mitigating measures to reinforce regulatory regimes and strengthen industry practice**

**1**

**Implement comprehensive, integrated and principles-based supervision of insurance groups**

**2**

**Strengthen liquidity risk management**

### **Additional measures to strengthen financial stability**

**3**

**Enhanced regulation of Financial Guarantee Insurance**

**4**

**Establish macro-prudential monitoring with appropriate insurance representation**

**5**

**Strengthen risk management practices and build on lessons learned**

## Insurance and financial stability - conclusion

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- The insurance industry weathered the financial crisis well and was not the source of the crisis.
- Insurers' core activities are not systemically relevant. A small number of quasi-banking activities alongside insurance either caused failure or triggered significant difficulties.
- Supervisors and policy-makers should focus on risk activities, not on institutions, when assessing systemic risk. Current and upcoming insurance regulatory regimes - economic and principle based - already adequately address insurance activities.
- The insurance industry is committed to contribute constructively to the debate of systemic risk and continue in its role as a financial system stabiliser.



# Questions?

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## Contacts

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