The Geneva Association: Striking the right balance with regulation

Mr Denis Kessler, Chairman and CEO, SCOR SE, and Board Member of The Geneva Association, underlines the need for regulation but also stresses that the key is finding the right balance between adequate and inadequate regulation. In this article taken from The Geneva Association's December 2010 PROGRES Newsletter, he looks at the role of regulation and says that the new regulatory framework should be "forward-looking".

The fundamental need for regulation arises from the fact that governments have a particular responsibility with regard to insureds: governments must guarantee proper procedure of successful insurance contracts' conclusion. This means supervising not just the quality, fairness and comprehensibility of the insurance contracts sold by insurance companies, but primarily supervising insurance companies' solvency.

The primary aim of supervision is to protect consumers, who are considered weak compared to powerful insurers, or unable to make a rational and fully informed selection of the best insurance product and the most solvent company.

Finding a balance in supervision

The supervision of insurers' solvency is a "second best" solution that substitutes a supervisory system operated by the public authorities when confronted with market imperfections. It is a "second best" solution in that it comes at the expense of economic efficiency. Therefore it is about reducing the risks of mismanagement and abuse, whilst keeping the insurance market sufficiently efficient and open to competition and new entrants.

It is important to bear this in mind because it helps us to avoid misunderstanding the ultimate goals of insurance supervision, which should not be to limit the role of the market in terms of allocating resources in the most efficient way and to fight against market forces, but to promote the market and help market forces to even out.

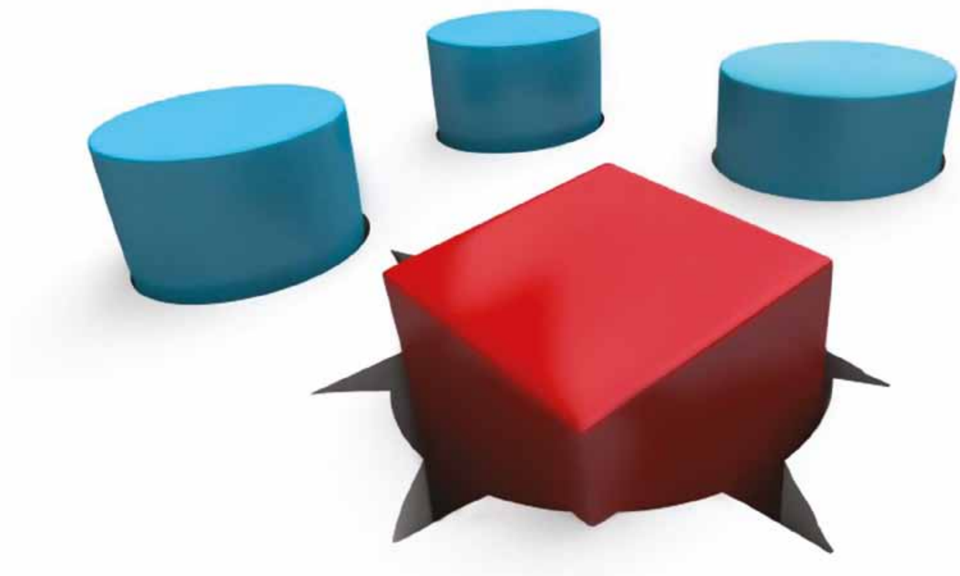
One should always be wary of introducing "maximal" regulation, which would be so stringent and heavy that it would dramatically reduce efficiency and competition between insurers...at the expense at the end of the day, of the insureds' best interests.

Thus, good supervision is a matter of balancing and not of safety at all costs, and has to take the specific features of each industry into account.

No "one-size-fits-all" regulation

Lack of global coordination has not been the only obstacle on the road to effective regulation. Another significant looming risk is that of amalgamation: the illusion that one solution fits all industries. Governments have focused on reforming the "financial services industry", ignoring the fact that this "industry" in fact comprises several very different segments. When it comes to regulation, one should not adopt a "one-size-fits-all" approach.

Confusion between the banking and insurance industries led to some fairly damaging solutions. For example, the catalyst that played a key role in the dissemination of the crisis was the liquidity crisis. Lack of liquidity—due to an incredible confidence crisis among banks—transformed the financial crisis into a potential systemic crisis. The financial system was on the brink of virtual collapse as trust vanished, and banks stopped lending money to each other. This liquidity trap could only be avoided through large-scale action by the Central Banks.



Insurance industry not prone to creating systemic risks

It is well known that the insurance industry does not rely so heavily on liquidity. In fact, the insurance industry is a net provider of liquidity and resources to other economic agents.

For this reason, the insurance industry is not prone to creating systemic risk. Furthermore, insurance contracts cannot be cancelled as easily as many banking or deposit contracts. Bankruptcy can happen in a day. When an insurance company is becoming illiquid, it is because it is for a long time insolvent and not because of independent liquidity problems.

In fact, insurance and reinsurance provide stability to the world economy thanks to their shock-absorbing capacity and very high resilience. This fact has unfortunately been overlooked by governments and regulators.

An efficient regulatory process should bear this detail in mind, and build on it. If the true target of regulation is to provide stability, policymakers should be doing everything they can to promote insurance as a key way to limit fluctuations.

Dangers of inadequate regulation

The dangers involved in inadequate or suboptimal regulation are far worse than just being unable to anticipate the next crisis.

The key issue here is that inadequate regulation creates loopholes, which transform themselves into arbitrage opportunities for economic agents. For this reason, regulation should be "forward-looking", rather than trying to address past crises. Wing-mirror driving is a dangerous exercise. The regulatory toolbox should include new tools, and not focus purely on quantitative aspects such as solvency.

The new regulatory framework should very much be forward-looking and focused on anticipating future trends. In this perspective, new regulations should incite the development of active risk management at the level of each insurance and reinsurance company.

Some global regulation already rests on a very prospective view of each insurance company's development. This is really the optimal situation. Regulation should be as close as possible to the business plan and risk profile of each company and try to assess if the capital management of each company is fully consistent with its business plan.

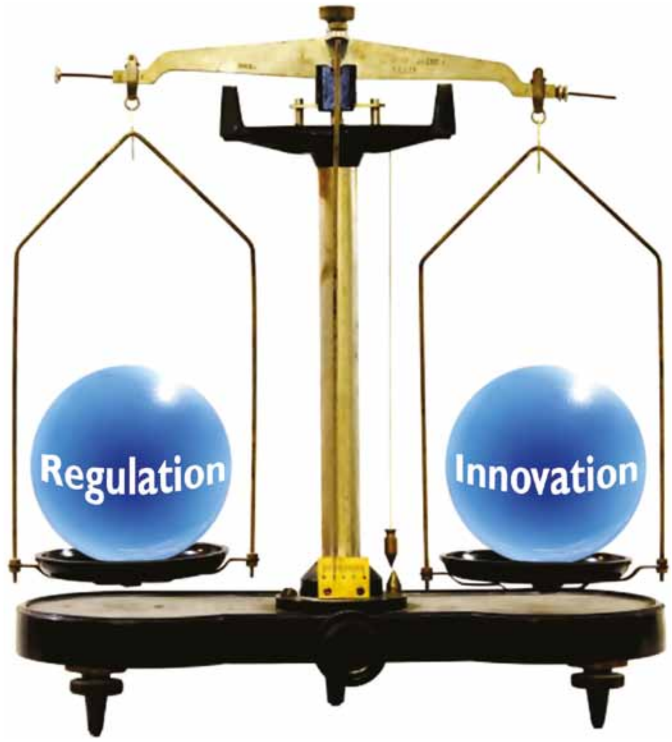
Moreover, it is the responsibility of each insurance or reinsurance company to define its specific risk appetite, and therefore the implied probability of loss and ruin.

Concluding remarks

After such a crisis, there is clearly a bitter taste in the mouths of all economic agents: companies, regulators, governments and public opinion.

They all think that the crisis could have been avoided, .and that others played a key role in its creation. From this point of view, bankers were largely the victims of a finger-pointing exercise. Although this type of reaction is understandable, it is overly simplistic. Focusing on bankers allows us to avoid questioning the role of public authorities and governments.

More fundamentally, however, it would be illusory to aim for a fluctuation-free environment and an absolutely stable world. Modern societies live in a philistine "petit-



bourgeois" dream of comfort and certainty. One should consider instead that cycles are consubstantial with economic and financial markets. Flattening cycles is already difficult; eradicating them is pure fantasy.

The future of regulation lies in providing an optimal framework for economic activities in order to reduce the amplitude of cycle oscillations.

Insureds should of course be protected from mismanagement by companies and from the irrational and foolish behaviour of managers. Ultimately, however, insureds are responsible for choosing one insurance company over another. In most cases, difficulties for an insurance company will lead to a run off or a portfolio transfer.

More and more countries have implemented guarantee funds and resolution procedures to cope with the total failure of insurance companies. A regulatory system that is too prescriptive would create new arbitrage opportunities, and eventually lead to a new crisis.

Any regulation should aim to temper competition, not to eradicate it: otherwise innovation would stop and, all things being equal, rates would increase. Regulation is a question of striking the right balance and right incentive, and not a question of maximum cautiousness that would be source of financial imbalances and that would give the wrong incentive with regard to risk transfer between economic agents.