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26. 02. 2010

International Association for the Study of Insurance Economics

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Geneva Association Information Newsletter

Geneva, February 2010

No Systemic Risk from Insurance Core Activities—Findings of The Geneva Association Special Report on Systemic Risk in Insurance

Geneva, 26 February 2010. Leading international insurance think tank, The Geneva Association, today published a special report analysing the role of insurance in financial stability and its systemic relevance. The report has been provided to inform and support supervisors and policymakers in their discussions on the development of measures to address the complex problem of systemic risk underlined during the financial crisis.

In the report, the differing roles of insurers and banks in the global financial system and their impact on the crisis are examined. A key conclusion of the analysis is that the core activities of insurers and reinsurers do not pose systemic risks due to the specific features of the industry:

- Insurance is funded by up-front premia, giving insurers strong operating cash-flow without the requirement for wholesale funding;
- Insurance policies are generally long-term, with controlled outflows, enabling insurers to act as stabilisers to the financial system;
- During the hard test of the financial crisis, insurers maintained relatively steady capacity, business volumes and prices.

Applying the most commonly cited definition of systemic risk, that of the Financial Stability Board (FSB), to the core activities of insurers and reinsurers, the report concludes that none are systemically relevant for at least one of the following reasons:

- Their limited size means that there would not be disruptive effects on financial markets;
- An insurance insolvency develops slowly and can often be absorbed by, for example, capital raising, or, in a worst case, an orderly wind down;
- The features of the interrelationships of insurance activities mean that contagion risk would be limited.

The report underlines that supervisors and policymakers should focus on activities rather than financial institutions when introducing new regulation and that upcoming insurance regulatory regimes, such as Solvency II in the European Union, already adequately address insurance activities.

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However, during the financial crisis, a small number of quasi-banking activities conducted by insurers either caused failure or triggered significant difficulties. The report therefore identifies two activities which, when conducted on a widespread scale without proper risk control frameworks, have the potential for systemic relevance.

- Derivatives trading on non-insurance balance sheets;
- Mis-management of short-term funding from commercial paper or securities lending.

The industry has put forward five recommendations to address these particular activities and strengthen financial stability:

- The implementation of a comprehensive, integrated and principle-based supervision framework for insurance groups, in order to capture, among other things, any non-insurance activities such as excessive derivative activities.
- Strengthening liquidity risk management, particularly to address potential mis-management issues related to short-term funding.
- Enhancement of the regulation of financial guarantee insurance, which has a very different business model than traditional insurance.
- The establishment of macro-prudential monitoring with appropriate insurance representation.
- The strengthening of industry risk management practices to build on the lessons learned by the industry and the sharing experiences with supervisors on a global scale.

Dr Nikolaus von Bomhard, Chairman of The Geneva Association and CEO of Munich Re said, *"In the public debate, the business model of insurance is unfortunately not always sufficiently demarcated from the business models of other financial services providers, such as banks. The way systemic risks are addressed must, however, take account of precisely the specific differences and characteristics of the business models and particular activities carried out by institutions. Just looking at the obvious differences, the conclusion can only be that the insurance industry in its core activities does not pose systemic risks for the economy."*

Patrick M. Liedtke, Secretary General and Managing Director of The Geneva Association said, *"The analysis carried out in this Geneva Association report, using the FSB's criteria for systemic risk, is a positive contribution to the global debate on insurance and financial stability. It demonstrates that the insurance industry is taking an active and cooperative approach to engagement with regulators and policymakers in this matter."*

Dr Stefan Lippe, Board Member of The Geneva Association and CEO of Swiss Re commented, *"Global and large insurers and reinsurers play an important role in supporting the global economy, they are shock-absorbers as they have long-term investment strategies. In this respect they contribute significantly to financial stability."*

Andrew Moss, hosting the conference as a Board Member of The Geneva Association and CEO of Aviva said, *"The insurance industry with its strong cash flows and well funded customer contracts is a source of stability in the financial system. These recommendations will enhance the regulatory framework, strengthen consumer protection and support the industry's capacity to provide investment to the real economy."*

A summary of the report follows this page. The press conference will take place at the Aviva offices, 1 Undershaft, London, EC3 at 10am today, Friday 26 February 2010.

A copy of the systemic risk in insurance report is available on The Geneva Association website at the following link:
http://www.genevaassociation.org/Portals/0/Geneva_Association_Systemic_Risk_in_Insurance_Report_March2010.pdf

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Report Summary

Significant Differences Between Banks and Insurers

The insurance business model—encompassing both insurers and reinsurers—has specific features that make it a source of stability in the financial system. Insurance is funded by up-front premia, giving insurers strong operating cash-flow without requiring wholesale funding. Insurance policies are generally long-term, with controlled outflows, enabling insurers to act as stabilisers to the financial system. During the crisis, insurers maintained relatively steady capacity, business volumes and prices.

Those few insurers who experienced serious difficulties, most notably AIG, were affected, not by their insurance business, but by their quasi-banking activities. Similarly, the troubled “monoliners” (FSA, AMBAC, MBIA *et al.*) concentrated exclusively on financial guarantees and Credit Default Swaps and trading. More than 90 per cent of State support to insurers went to those with significant, failing non-insurance businesses.

Core Insurance Activity Poses No Systemic Risk

The FSB uses three criteria to assess the systemic risk presented by an institution: size, interconnectedness and substitutability. The International Association of Insurance Supervisors (IAIS) has added time—that is, the speed of loss transmission to third parties—as a fourth criterion. This is of particular relevance to insurance, as insurance claims, unlike banking obligations, do not immediately generate cash outflows.

The report does not dispute these criteria for systemic risk. Even more importantly for the regulatory purposes, they show how systemic risk accrues, not to firms, but to specific activities of those firms.

Applying the FSB criteria to the main activities of insurers and reinsurers, the report concludes that neither poses a systemic risk.

The report finds that only two non-core activities of insurers could have the potential for systemic relevance, assuming that they are conducted on a huge scale and using poor risk control frameworks:

- derivatives trading on non-insurance balance sheets;
- mis-management of short-term funding from commercial paper or securities lending.

Principle-Based Group Supervision Mitigates Potential Systemic Risk

Current and already approved insurance regulatory regimes adequately address core insurance activities. The remaining question is whether existing regulation adequately mitigates potential systemic risk from the aforementioned non-core activities or whether it needs supplementing or replacing with new measures.

The report concludes that principle-based group supervision applied to all entities within an insurance group (regulated and non-regulated), supported by sound industry risk-management practices, will mitigate potential systemic risk related to these activities.

In the European Union, Solvency II represents a comprehensive risk and economic- based regulatory framework but should not be confused with the banking regulation Basel II.

Insurer Insolvencies Currently Handled in Orderly Manner

The report shows that insolvencies need not be avoided at any price. Faced with a very large event, an insurer can fail; but, in contrast to what has been witnessed in the banking sector, winding-up an

insurer is an orderly process that does not generate systemic risk. However, cross-border crisis management remains an area requiring improved coordination among supervisors.

Regulatory Focus to be Based on Risk Activities and not on Institutions
In seeking to close remaining gaps in the supervisory framework, regulators should avoid the temptation to place special burdens on specific institutions. This approach could distort the insurance market by skewing pricing, reducing aggregate market risk-bearing capacity, drawing supervisors' attention away from risky activities going on elsewhere, and creating moral hazard in these "too big to fail" institutions. The consequences of getting systemic risk reforms wrong would not only be severely damaging to the insurance industry but to the economy as well.

Five Recommendations
In order to strengthen financial stability, regulatory oversight and industry risk practices, the report recommends five measures:

1. The implementation of a comprehensive, integrated and principle-based supervision framework for insurance groups, in order to capture, among other things, any non-insurance activities such as excessive derivative activities.
2. Strengthening liquidity risk management, particularly to address potential mis-management issues related to short-term funding.
3. Enhancement of the regulation of financial guarantee insurance, which has a very different business model than traditional insurance.
4. The establishment of macro-prudential monitoring with appropriate insurance representation.
5. The strengthening of industry risk management practices to build on the lessons learned by the industry and the sharing experiences with supervisors on a global scale.

These recommendations demonstrate the insurance industry's commitment to contribute to the discussion on systemic risk, to add to the stability of the overall financial system, and to perform its enabling role in the real economy.

The Geneva Association

The Geneva Association is the leading international insurance "think tank" for strategically important insurance and risk management issues.

The Geneva Association identifies fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. Through the development of research programmes, regular publications and the organisation of international meetings, The Geneva Association serves as a catalyst for progress in the understanding of risk and insurance matters and acts as an information creator and disseminator. It is the leading voice of the largest insurance groups worldwide in the dialogue with international institutions. In parallel, it advances—in economic and cultural terms—the development and application of risk management and the understanding of uncertainty in the modern economy

The Geneva Association membership comprises a statutory maximum of 80 Chief Executive Officers (CEOs) from the world's top (re)insurance companies. It organises international expert networks and manages discussion platforms for senior insurance executives and specialists as well as policy-makers, regulators and multilateral organisations. The Geneva Association's annual General Assembly is the most prestigious gathering of leading insurance CEOs worldwide.

Established in 1973, The Geneva Association, officially the "International Association for the Study of Insurance Economics", is based in Geneva, Switzerland and is a non-profit organisation funded by its members.

For more information please visit *www.genevaassociation.org*.