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When are insurers systemically important?

Lisa Pollack Jul 30 2012 13:05 18 comments

Banks are interconnected, and carry systemic risk to the economy. One doesn't need the experience of a crisis to know this, it's just intuitive.

On a similarly intuitive basis, are *insurers* systemically important?

Do they need to be made to hold extra capital and have living wills for potential resolution like our most important banks should, and will?

Without a doubt, when an insurer walks, talks, and acts like a bank, it should indeed be treated as one when it comes to the Systemically Important Financial Institution (SIFI) label. Ditto if the insurer is leaned on extensively by banks, as provider of a service on which banks depend — for example, writing credit default swaps on banks' structured securities.

But what of the actual business of insurance? Can that be systemically risky?

The industry itself gives a wholly unsurprising answer: no, the traditional insurance model is not destabilising, it held up well through the crisis, and therefore shouldn't be a target of the additional burdens that will come with being labelled a SIFI.

The basis of the "insurance-isn't-risky-like-that" argument was described in a regulatory briefing by PWC (emphasis ours):

> **The insurance business model is based upon the assumption of a large number of ideally uncorrelated risks from policyholders to establish and maintain a well-diversified portfolio.** As articulated in the rule, insurance is founded on the law of large numbers, which states that the aggregation of a large number of idiosyncratic risks ultimately results in a normal curve of distribution. **As such, there is less opportunity for unexpected results and a lower probability of large losses, in relation to the entire portfolio.**

This pooling of risks means that, at some level, bigger is better (so they say):

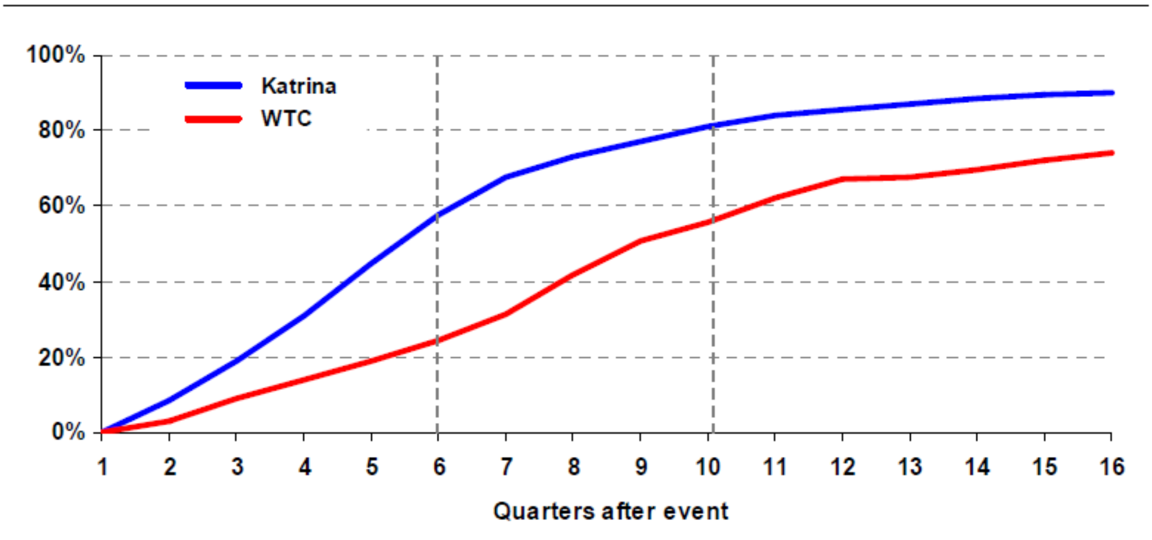
> **Unlike banks, the risk profile of an insurer actually becomes less risky as**

> **more risks are assumed.**

It does seem a bit idealistic, asserting a normal distribution like that, but the law of large numbers argument is compelling — particularly when it comes to sectors such as life insurance.

As for those huge risks like natural and man-made disasters, one thing that decreases risk for the insurer is that the process of granting payouts is typically much more lengthy than the binary events they trigger, as this graph from a report on *Insurance and Financial Stability* by the International Association of Insurance Supervisors (IAIS) shows:

Figure 1: Catastrophe reinsurance loss payments in per cent of ultimate losses



Source: Reinsurance Association of America; assumed reinsurace losses

Given all of this, the IAIS thinks that the focus should rather be on the non-core activities of insurers when trying to determine if they are globally systemically important. Back to PWC:

> **The potential for systemic risk with the insurance sector therefore needs to be considered when insurers deviate from the traditional insurance model and enter into non-traditional insurance or non-insurance activities.** Accordingly, in determining an insurer's relative score, the IAIS has proposed significantly higher weights for non-traditional and non-insurance activities and interconnectedness categories.

For examples of "non-insurance" or "non-traditional insurance" look no further than AIG and the monolines that "insured" all manner of structured products — which is, of course, what is trying to be captured with all of this.

The IAIS published proposed guidelines on how to spot a Globally Systemically Important Insurer (G-SII) at the end of May and the comment period closes on Tuesday. It's thought that the first list of G-SIIs will be published in the first half of 2013, tacking them onto the list of

~~global badasses~~ ~~too-big-to-fail institutions~~ G-SIFIs. Something like the following then awaits them (taken from the FAQ published by the IAIS):

> • Improving the authorities' ability to resolve G-SIFIs in an orderly manner without destabilising the financial system and exposing the taxpayer to the risk of loss,
>
> • Requiring higher loss absorbency for G-SIFIs to reflect the greater risks that these institutions pose to the global financial system,
>
> • More intensive and co-ordinated supervision of G-SIFIs,
>
> • Strengthening core financial infrastructures, and
>
> • Other supplementary prudential and other requirements as determined by the national authorities

All well and good. Back to the beginning though: when is an insurer a G-SII? The IAIS proposes the following criteria, where a lot of weight is put on all the non-traditional, non-insurer-y stuff as per the arguments given above (table supplied PWC):

Category	Category weighting (%)	Individual indicator	Indicator weighting (%)
Size	5–10	• Total assets • Total revenues	2.5–5
Global activity	5–10	• Revenues derived outside of home country • Number of countries	2.5–5
Interconnected ness	30–40	• Intra-financial assets • Intra-financial liabilities • Reinsurance • Derivatives • Large exposures • Turnover • Level 3 assets	4.3–5.7
Non-traditional and non-insurance activities	40–50	• Non-policyholder liabilities and non-insurance revenues • Derivatives trading • Short-term funding • Financial guarantees • Viable annuities • Intra-group commitments	6.7–8.3
Substitutability	5–10	• Premiums for specific business lines	5–10

When it comes to banks, "size" and "global activity" carry a lot of weight when granting entry to the G-SIFI club. Not so much with insurers, propose the IAIS. What the above criteria are clearly aimed at is catching the securities lending and credit default swap activity of insurers — see again: AIG and the monolines. Any criteria will no doubt be back-tested on them. But also the hope is that it'll cover other risky shenanigans that insurers get into in the future.

There is, however, a big alarm bell that should be going off here — the subjective nature of some of the supposedly objective measures.

What is a “non-insurance revenue” exactly? The classification of assets as Level 2 or 3 also has a certain amount of flexibility too, and so on. The IAIS are not blind to the issue and they summarise it themselves with the below table that tries to capture the many shades of grey between traditional and non-traditional insurance activities:

Table 1: Illustrative allocation of activities conducted by insurance-focused groups[16]

		Traditional ➡		⬅ Non-traditional
Insurance	Underwriting	• Most life and non-life (re)insurance business lines	• Life insurance and variable annuities with additional guarantees • Mortgage guarantee insurance • Trade credit insurance	• Alternative risk transfer (ART), incl. Insurance-linked securities (ILS) • Financial guarantee insurance • Finite reinsurance
	Investments and funding	• Proprietary investment function (ALM) • Hedging for ALM purposes • Funding through equity and debt issues; also securities lending	• Proprietary and derivatives trading (non ALM) • Property management (related to investment portfolio)	• Purely synthetic investment portfolios • Cascades of repos and securities lending • Scope and scale of activities beyond insurance remit
Non-insurance		• CDS/CDO underwriting • Capital market business • Banking, incl. investment banking and hedge fund activities • Third-party asset management • Industrial activities		

Soul-searching question of the day: with things like this, are we making the financial system more stable, or are we giving those who want to circumvent the rules a roadmap for how to do so?

Thoughts welcome.

Related links:
G-SIIs vs. G-SIFIs: Lines blur between insurance and banking – PWC
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