

# Standard & Poor's European Insurance Symposium

Is (re)insurance systemic?

Denis Kessler, Chairman & CEO

29 June 2011



## The hangover: synopsis of a very bad trip

- ❑ A blowout Las Vegas bachelor party turns into a race against time when three hung-over groomsmen awaken after a night of drunken debauchery to find that the groom has gone missing, and attempt to get him to the alter in time for his wedding.
  - ❑ The next morning, the groomsmen come to their Palace suite to find a tiger in the bathroom and a six-month-old baby tucked away in the closet.
  - ❑ With no memory of the previous night's transgressions and precious little time to spare, the trio sets out in a hazy attempt to retrace their steps and discover exactly where things went wrong.
- **Where did things go wrong? What went wrong?**



## Setting the stage of a nightmare trial

---

- ❑ The Plaintiff: Mr. Financial Stability Board (« FSB »)
  - Fully backed by the Gang 20 (« G20 »)
  - Missioned to ensure global financial stability



- ❑ The Defendants: Mr. Insurance and Mrs Reinsurance
  - The Defendants plead not guilty



- ❑ The Judge states the offence
  - The Defendants are accused of being source of systemic risk to the detriment of financial stability, at the expense of policyholders, taxpayers and citizens



## Would the accused please stand, and listen to the reading of the offence?

---

- ❑ The Attorney General may read the accusation act
- ❑ We, the FSB, take into consideration « systemic risk » defined in the following way:
  - “The risk of disruption to the flow of financial services that (i) is 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
- ❑ We, the FSB, accuse the Defendants of potentially creating a systemic risk, based on three charges:
  1. Size: “The volume of the financial services provided by the individual component of the financial system”
  2. Interconnectedness: “Linkages with other components of the system”
  3. Substitutability: “The extent to which other components of the system can provide the same services in the event of a failure”
- ❑ “Given their size, interconnectedness and low level of substitutability, Insurers and Reinsurers are accused of potentially creating systemic risk”



## Defendants may speak



- ❑ “Your Honour, there is a horrible confusion and a terrible mistake:
  - We are insurers and reinsurers. We are neither bankers, nor hedge funds...
  - We are potential victims of systemic risk, not cause of systemic risk
  - The Plaintiff gets confused between “systemic risk” and “severe financial crisis”, between individual failures and full system collapse”
  - The Plaintiff seems to ignore insurance and reinsurance activities’ fundamentals
  
- ❑ “To answer the three counts of the accusation:
  1. Size: As compared to banks, the insurance and reinsurance sectors have a limited size (by balance sheet and exposures)
    - Contrary to what is affirmed, insurers and reinsurers’ failure would not have a disruptive effect on financial markets and the system as a whole
  2. Interconnectedness: the low level of interaction does not create contagion. This is also true between insurers and reinsurers
  3. Substitutability: Competition is such that the failure of a player would easily be replaced by other players: there is no shortage risk”
  
- ❑ “Furthermore, please take into account timing: the speed of a failure is slow, allowing insurers to react by capital raise and/or orderly wind-up. Resolution is quasi always orderly”

## Defendants call experts to the bar: IAIS



- ❑ The IAIS (International Association of Insurance Supervisors ) is called to the bar
- ❑ What do experts have to say about the systemic nature of insurance and reinsurance?
- ❑ The judge asks: “as you are experts in supervision and regulation, tell me frankly if insurance and reinsurance are causes of systemic risk, or not?”
- ❑ IAIS’ answer:
  - We are working on it...
  - ... it is an ongoing work
  - ... and we need data”
- ❑ The judge asks furthermore: “Does the IAIS share the FSB’s analysis of systemic nature of insurance and reinsurance?”
  - IAIS’ answer: “not yet decided, we need data...”

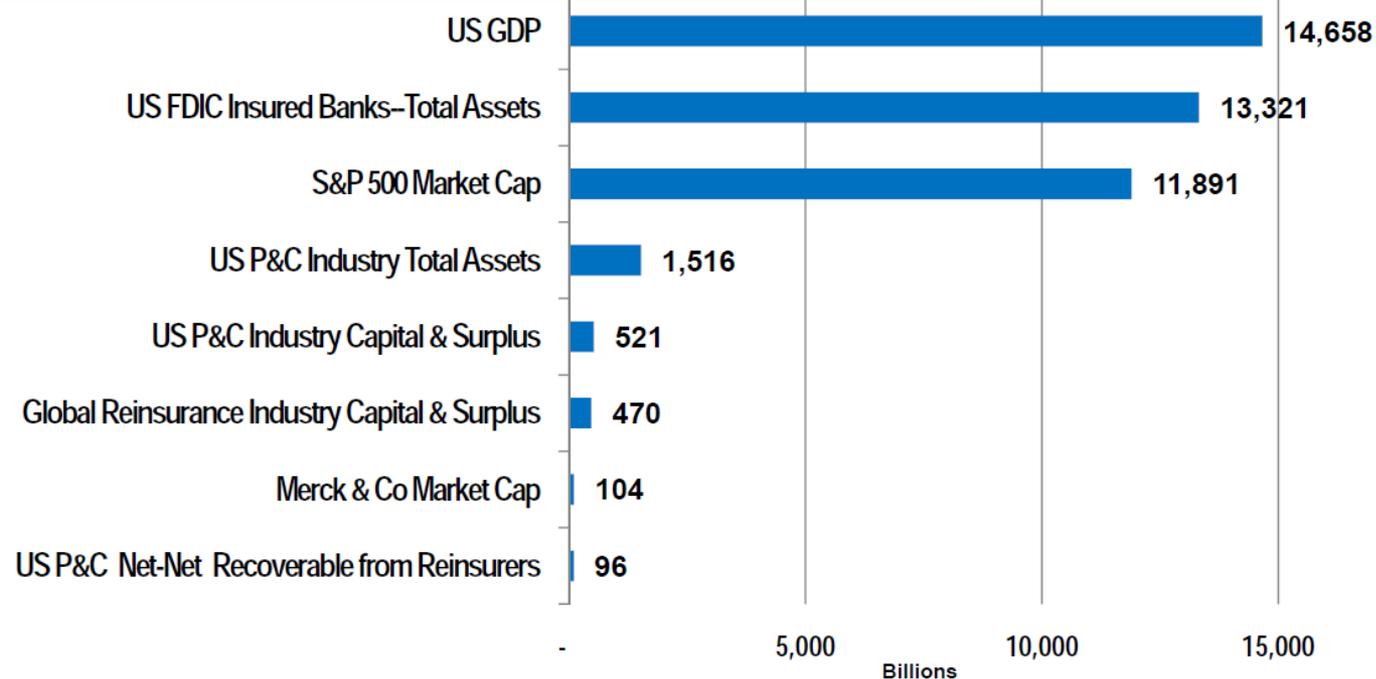


## Other experts are called to the bar: Reinsurance Association of America



- The RAA has published a report on 23 June 2011, demonstrating reinsurers do not meet the Financial Stability Board criteria of size, interconnectedness, substitutability or time/liquidity being applied to determine which insurers might be deemed to contribute to systemic risk in the insurance universe

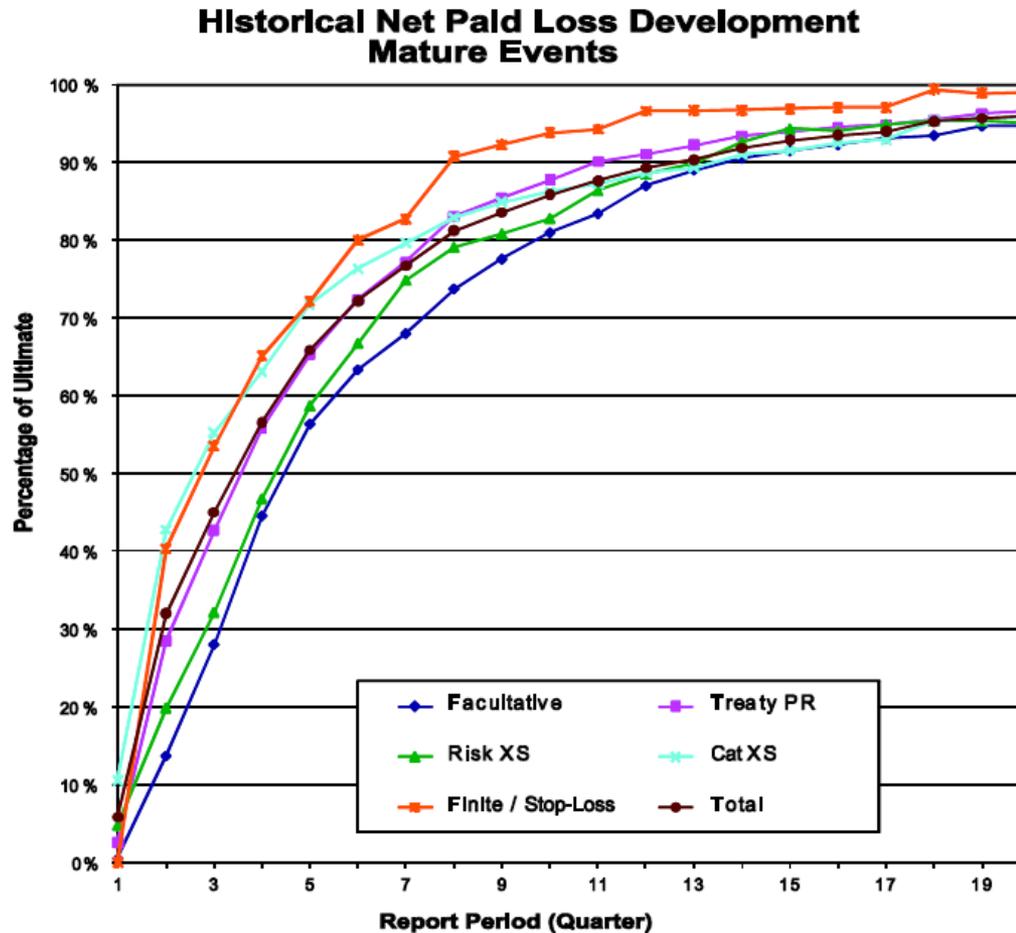
Size of reinsurance recoverables relative to U.S. Financial Markets or Economy is marginal



**RAA**  
REINSURANCE  
ASSOCIATION  
OF AMERICA

# Further evidence from Reinsurance Association of America

- Data published by the RAA demonstrates that claims are paid over a long period



## Other experts are called to the bar: Property Casualty Insurers of America



- *“Home, auto and business insurers do not pose a systemic risk. While the failure of such an insurer could have a short-term and limited impact on the availability and cost of insurance, it would not create systemic risk to other financial markets or the wider economy because of a unique combination of industry attributes, including:*
  1. *The nature of P&C products that insulate the insurance market from the risk of contagion;*
  2. *The highly competitive dynamics of the industry;*
  3. *The limited types and scope of P&C company investment risks; and*
  4. *The comprehensive regulatory and resolution systems governing P&C company activities that protects consumers”*

*Property Casualty Insurers Association of America  
June 1, 2011*



Property Casualty Insurers  
Association of America  

---

Shaping the Future of American Insurance

## Other experts are called to the bar: Geneva Association

- ❑ *“Business models and roles in the economy of insurers and banks are different*
  - *Traditional insurance activities have an inverted cycle of production (pre-funding of liabilities)*
  - *Asset liability management as a key characteristic for insurance activities*
  - *Banks are traditionally involved in maturity transformation, while insurers typically do not take such risks*
- ❑ *Insurance companies have a proven and sound resolution mechanism that enables an orderly wind down over time*
- ❑ *No core insurance activity has ever triggered a systemic financial crisis”*



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

- ✘ **Size: Limited size of activities**
  - 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



## Last expert are called to the bar: Standard & Poor's!



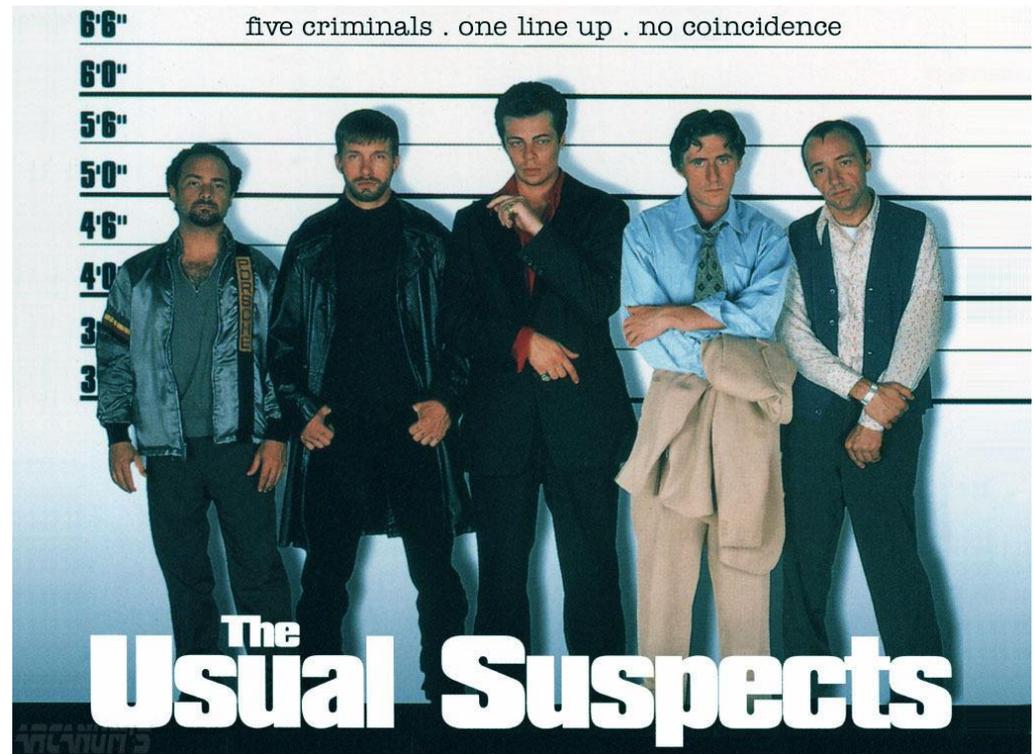
- Yesterday, S&P published an interesting report on “Rating Implications for G-SIFI-Designated Insurers », and makes several key statements:
  - *“A few insurers received government support during the financial crisis(...) Some bancassurance groups received support, but mainly in respect of their banking activities”*
  - *“Beyond bond insurance and trade credit, few lines of business in insurance produce amplification of risk because most insurance products are only loosely correlated with the economic volatility or not correlated at all.”*
  - *“In our experience the insurance business model rarely gives rise to liquidity and refinancing concerns (...) Asset liquidity is generally very high, insurers are generally not highly leveraged”*
  - *“Reinsurers could be seen as highly interconnected with primary insurers. However, as long as the provision of reinsurance remains as diversified as it is currently, we would expect systemic risk to be limited. Several reinsurers have failed over the past two decades (...). There were no associated material systemic implications »*



# Plaintiffs: Bankers, Hedge Funds, Insurers and Reinsurers, they are all usual suspects of financial difficulties



- ❑ “You are all “Financial Institutions””
- ❑ “Plaintiffs are acting for the Good Cause of “Stability”, against all those financial institutions who create:
  - Disruptions
  - Discontinuities
  - Dislocations
  - Distress”
- ❑ “Insurers and Reinsurers are actors of potential massive destruction of the World of Stability”
- ❑ Plaintiffs ask for a very tight control of those delinquents



## Could you give us facts? Defendants may speak

- The Defendants: “Your Honour, Mr Insurance and Mrs Reinsurance have always perfectly behaved in the past, they have always adopted a prudent behaviour:
  - There is no historical record of them undermining the stability of the financial system
  - To the contrary of what the accusation affirms and pretends, there is even evidence that Mr Insurance and Mrs Reinsurance have always been a factor of stability”
  - Furthermore, insurance and reinsurance are closely regulated industries, by the members of IAIS”



- The Attorney General : “The defence seems to forget that there has been failures of certain insurance companies in the past, and that a large company was bailed-out by a government, and that there were concerns in the 1990’ s of a spiral that could have been destructive ?”
- The Defendants: “ Your Honour, the fact that some insurance companies may have faced difficulties, and even got into run off is of course true. But systemic risk has nothing to do with companies failures. The large insurance company you are referring to, as Ben Bernanke stated it, was a hedge fund practising sometimes insurance operations. Its insurance operations did not fail”.
- “The past is talking in our favour and during the recent financial crisis, we demonstrated that systemic risk is intrinsic to the banking system and that insurance and reinsurance are indeed a stabilizing factor”



# Could you give us further arguments why you are not creators of systemic risk?



1. “Extreme events covered by (re)insurance, such as pandemics or terrorist attacks, may be systemic but it is not the eventual failure of (re)insurance companies that may transform these events into systemic risks;
2. As opposed to banking, insurance operations are not exposed to liquidity risk, which has been historically at the core of systemic risk
  - (Re)insurance operations span over a on long time horizon, and are always in positive cash flow territory;
  - Life insurers can experience high lapse rates that can be a brutal disruptions – but different from a systemic risk as such
3. Insurance is only weakly indebted, with no off-balance sheet exposures, which are typical of banking activities by definition
  - Insurance risks stay on balance sheet; and those insurers who had material off balance exposures were actually undertaking banking operations;
4. Monoliners’ activity has to be considered separately
  - It resorts to activities that rest either on an important implication of governments, and their implicit guarantee, or on quasi-banking that has escaped to supervision because of the lack of coordination and attention of supervisors;
5. Have you ever heard of “*insuranceruptcy*”?
  - But I am familiar with “*bankruptcy*”, which plays always a key role in the propagation of systemic shocks. The insurance industry resort to *run off* where contracts are not interrupted and they are cleared over many years according to their duration.”

---

What will the judge decide?

The story is still on-going

Two potential outcomes for the on-going trial

## Outcome 1: Mr. Insurance and Mrs. Reinsurance are guilty



- ❑ Mr Judge comes up with a list of 50 systematically relevant insurers, of which 10 reinsurers
- ❑ Some of the insurers and reinsurers are considered as potentially “dangerous”, and likely to create a systemic risk endangering the whole financial stability
- ❑ They will be called “SIFI”, clearly flagged and will have to carry an electronic tag, wear an orange jump suit, they will be under permanent surveillance and monitoring
- ❑ They will wear heavy “capital chains”, they will have to write a living will, undergo legal restructuring and pay heavy fines to contribute to bail out funds to compensate their victims



# Outcome 1: The introduction of SIFIs has still some opened consequences

---



- ? Could we assist to a “flight to SIFI”?
  - Insureds wishing to benefit from the potential implicit government guarantee and backing. This would be an adverse effect, detrimental to non-SIFI entities
  
- ? Will the extra capital charge be commensurate with the 1 - 3,5% of Risk Weighted Assets considered for banks?
  
- ? How will those new capital requirements interfere with Solvency II?
  
- ? Will rating agencies upgrade SIFIs, fuelling further the flight to SIFI?
  - In its 28 June report, S&P wrote: “*We believe the rating consequences for insurers that are designated as SIFIs could be either negative or positive*”

## Outcome 1: Mr. Insurance and Mrs. Reinsurance are guilty

---



- ❑ Astonishment on all benches...
- ❑ ... except on the bankers' bench where we perceive a sigh of relief and discrete smiles
- ❑ The FSB triumphs!
- ❑ We enter the World of Regulator II



## Outcome 2: Mr. Insurance and Mrs. Reinsurance are declared innocent



- ❑ The judge understands key issues at stake:
  1. Neither insurance nor reinsurance companies create systemic risk
  2. On-going improvements of insurance and reinsurance regulation (Solvency II) will add further stability
  3. The judge considers that creating SIFIs would generate competition distortions and reduce insurers and reinsurers' profitability at the expense of solvency
  4. The judge considers that increased cooperation between regulators is the optimal path to follow
  
- ❑ Applauses on the insurance and reinsurance bench

