

Global Systemically Important Insurers

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Abstract

This paper addresses the issue of systemic risk in the financial sector and its relevance with regard to insurance activities. The initiatives which followed the 2008 global financial crisis to address the risks posed by Systemically Important Financial Institutions are analyzed, with a focus on the Global Systemically Important Insurers Designation Process and Policy Measures, developed by the International Association of Insurance Supervisors and adopted by the Financial Stability Board in July 2013. The potential consequences of the SIFI project for financial stability, in general, and the Global Systemically Important Insurers framework, in particular, are also discussed. The incentives which are being introduced for the reduction of systemic risk may have unintended consequences, such as an increase of moral hazard and intensified uncertainty. The ongoing work regarding the design, calibration and, in some cases, implementation of such policy measures is, therefore, of capital importance.

1. Introduction

The global financial crisis highlighted the need for public authorities to act in the identification of systemically important financial institutions (SIFIs) and the definition of policy measures aimed at reducing the moral hazard risk as well as the impact of their disorderly failure. Underlying the debate laid the question about the existence of systemic risk and the extent to which it could be addressed through the introduction of additional supervisory measures. The establishment of the Financial Stability Board (FSB), in April 2009, brought new intensity to the debate, leading to the publication of concrete policy recommendations to be introduced in the regulation of financial markets.

The International Association of Insurance Supervisors (IAIS) has been playing an important role in this global initiative. Under the leadership and steering of the FSB, the IAIS has focused on the analysis of the potential systemic relevance of insurers. For this purpose, the IAIS has developed a methodology to assess and ultimately identify global systemically important insurers (G-SIIs), as well as a range of policy measures to be applied to them. The first cohort of G-SIIs has been announced in July 2013. Work is currently proceeding at a fast pace in two fronts: G-SIIs are strongly involved in the implementation of the most immediate measures, whereas the IAIS is pushing for the conclusion of other relevant initiatives such as the development of global capital standards, under challenging timelines.

The remainder of this paper is organized as follows. In Section 2, the definition of systemic risk and its application to insurance is discussed. Section 3 details the IAIS G-SII identification methodology. The policy measures which will be

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applied to G-SIIs are detailed in Section 4. Section 5 explores some of the potential consequences, both positive and negative, of the SIFI and G-SII initiatives to financial stability. Finally, Section 6 presents some conclusions and areas for future work.

2. Systemic Risk in Insurance

The debate regarding the systemic nature of insurance business has been ongoing for many years, with particular intensity in the aftermath of the global financial crisis. The International Monetary Fund (IMF) (2009), in cooperation with the Financial Stability Board (FSB) and the Bank of International Settlements (BIS) developed the working definition of systemic risk as 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. The two main components of this definition were furthermore refined. On the one side, it was specified that the impairment of the flow of financial services might include both situations of temporary unavailability of services as well as cases where the cost of these services would register a sharp increase. On the second issue, the clarification was that the relevant impact on the real economy, necessary for an event to be classified as systemic, could take place either through the demand or supply side. From an insurance perspective, the discussion about the topic of systemic risk usually revolves around three different perspectives: the way in which insurers are affected by risks emanating from other parts of the financial sector; the reaction of insurers to these shocks, contributing to their amplification or mitigation; and, finally, the issue of whether insurers can be themselves the source of systemic risk.

The IAIS (2009) suggested that the specificities of the insurance activity should be duly considered when attempting to extend this broad definition to the insurance sector, namely regarding the specificities of underwriting (inverted cycle) and the risk management approach which is adopted (focus on Asset-Liability Matching). Although it is recognized that insurance is a financial sector with significant links to the real economy, it differs from the other financial services by its business model which is based on the transfer of risk to insurers through an “inverted cycle of production”. This means that insurance undertakings collect premiums at the inception of the contract, in exchange for the payment of claims which may arise during or after the end of the contract.

Contrary to other financial sectors, insurance business does not significantly depend on debt financing, but insurers are instead large long term institutional investors in the economy. The links to the real economy are therefore present on both sides of their balance sheet, through long term investments on the asset side and by the assumption of underwriting risks recognized as insurance liabilities. Taking into consideration these specificities and the way they could affect the systemic relevance of insurers, the IAIS proposed the addition of a

timing-related fourth sub-element, to complement the three originally developed: size, lack of substitutability and interconnectedness. This would allow the recognition of all potential forms of systemic risk, including that eventually originating from the insurance sector (considered to materialize over longer time horizons, rather than generate immediate shock effects).

Furthermore, IAIS (2011) concluded that insurance activity is different from banking activity and therefore traditional insurance activities were not seen as giving rise to any systemic risk. Only those entities exploring non-traditional or non-insurance activities can be more vulnerable to financial market developments and, therefore, be more likely to amplify or contribute to systemic risk. Examples of such activities are financial guarantee insurance, underwriting of credit default swaps, transactions for non-hedging purposes, derivatives trading or leveraging of assets to enhance investment returns. These views are consistent with the findings of Eling and Pankoke (2012), who conclude that, although insurance companies are less prone to systemic risk and less vulnerable than banks, some non-traditional activities may entail some risk, namely due to the high leverage and implied guarantees associated with them. Baranoff *et al* (2012) also concluded that core insurance activities did not give rise to systemic risk, only derivatives for speculation and mismanagement of short-term investments could give rise to such risks in the insurance sector. Other studies, such as Cummins and Weiss (2011) and Klein (2011), point to similar conclusions. Focusing on the Dutch financial sector, Minderhoud (2003) concluded that systemic risk was particularly important due to the high level of concentration and large cross participations. Another conclusion was that the carrying of life insurance activities by banks might increase systemic risk, possibly due to the common high exposure of life insurers to securities markets.

IAA (2013) highlighted the fact that banking, insurance and financial markets continue to evolve, driven by technology towards greater economies of scale and significantly more complex strategies, tactics and operations. The increase of inter-dependencies in the global markets did not allow to completely exclude the possibility that, in the future, some entities in the insurance sector could be the cause of a systemic risk event. However, there is no unanimity, both in the financial sector and in the academia, that the issue of systemic risk is in any case relevant, and even more so concerning the insurance sector. Black (1995) argued that it is the governmental intervention in the financial markets, by interfering with private contracting, that generates systemic risk in the first place. The subsequent interventions to tackle systemic risk would only contribute to further aggravate the problem. Geneva Association (2010) supported the view that the insurance sector is not source of systemic risk, as the specific business model of insurance undertakings makes them instead a source of financial stability. Furthermore, it was pointed out that, in the very few cases where insurance undertakings experienced serious difficulties during the crisis, this was mainly caused by their quasi-banking business, the main activities of insurers and reinsurers do not pose any systemic risk. Only non-core

insurance activities, such as derivatives trading, could be seen as giving rise to systemic risk.

3. G-SII Designation Process

The IAIS was called to support the global initiative of the identification of global systemically important financial institutions (G-SIFIs), under the coordination of the Financial Stability Board (FSB) and the G20, with focus in the field of insurance. The FSB explicitly stated the intention to extend the G-SIFI framework to cover insurance companies (FSB (2010)), mandating the IAIS to complete its assessment methodology for the identification of G-SIIs by 2013 (FSB (2011)). In this context, the IAIS developed an assessment methodology to identify insurance-dominated financial conglomerates whose distress or disorderly failure due to its size, complexity and/or interconnectedness could generate systemic risk. Hence, the working definition of G-SIIs which was adopted by IAIS was in line with the FSB's definition of G-SIFIs. The IAIS methodology was published in July 2013 (IAIS 2013a), in parallel with the FSB's publication of the first cohort of designated G-SIIs (FSB (2013)). The initial IAIS assessment methodology was developed with the support of a data collection exercise, using year-end 2011 data from selected insurers. Data was collected on a group level for 50 insurers in 14 jurisdictions on the following criteria:

- Insurance groups with total assets of USD 60 billion or more and a ratio of premiums from jurisdictions outside the home jurisdiction to total premiums of 5% or more;
- Insurance groups with total assets of USD 200 billion or more and a ratio of premiums from jurisdictions outside the home jurisdiction to total premiums between 0% and 5%;
- It also entailed insurers that were added by supervisors such as e.g. financial guarantee insurers.

According to the indicator approach, the IAIS defined selected indicators grouped into five categories: Size; Global Activity; Interconnectedness; Non-Traditional and Non-Insurance Activities; and, Substitutability. A total of 20 indicators were defined, aiming to capture the systemic importance of each insurer from a multitude of dimensions. To arrive at a final score for each insurer, weights were assigned to each category, as detailed in Table A2.1. After having the scores for all entities in the sample, they were ranked in descending order of systemic relevant, and a cut-off point was defined.

Table A2.1: Weights given to each category and individual indicator in IAIS indicator-based approach

Category	Category weighting	Individual indicator
Size	5%	Total assets
		Total revenues
Global activity	5%	Revenues derived outside of home country
		Number of countries
Interconnectedness	40%	Intra-financial assets
		Intra-financial liabilities
		Reinsurance
		Derivatives
		Large exposures
		Turnover
		Level 3 assets
Non-traditional insurance and non-insurance activities	45%	Non-policy holder liabilities and non-insurance revenues
		Derivatives trading
		Short term funding
		Financial guarantees
		Minimum guarantee on variable insurance products
		Intra-group commitments
		Liability liquidity
Substitutability	5%	Premiums for specific business lines

The indicator-based approach was subsequently complemented by an Insurance and Financial Stability (IFS) assessment approach. This consisted of a segmentation of the business portfolio into its traditional insurance, semi- and non-traditional components, as well as non-insurance financial and industrial activities. Then, risk weights were defined for each of the segments, consistently with IAIS stated position that the systemic importance of insurance is mainly associated the conduct of non-insurance financial and non-traditional insurance activities (IAIS (2011)). To arrive at a final score, these risk weights were multiplied by the assets of insurers, broken down according to the same segmentation. The indicator-based and the IFS assessment approaches were then complemented by a supervisory judgment and validation process, to ensure the overall methodology could produce a more robust assessment of the systemic importance of insurers. The IAIS envisages revisiting the assessment methodology, as a minimum, every three years, to reflect changes in the insurance markets and overall economy.

4. G-SII Policy Measures

On 18 July 2013, the FSB (2013) has formally announced the list of the first 9 G-SIIs based on the methodology described in the previous section. Already at its Summit meeting in Seoul, in November 2010, the G20 leaders had endorsed the FSB's framework for reducing the moral hazard posed by systemically important financial institutions. According to IAIS (2013a), this framework included several policies, focusing on the application of more intensive and coordinated supervision, increasing the ability to resolve SIFIs in an orderly manner, requiring higher loss absorbency to reflect the greater risks that these institutions pose to the global financial system, strengthening the core financial infrastructures and providing other requirements required by national authorities.

In line with this general statement, the IAIS (2013b) published in parallel the list of policy measures applicable to them:

- The application of the recovery and resolution planning requirements, defined under the FSB's Key Attributes², namely the establishment of Crisis Management Groups (which should carry out resolvability assessments), the development of Recovery and Resolution Plans including liquidity risk management plans and, finally, the development of institution-specific cross-border cooperation agreements among relevant resolution authorities;
- Enhanced group-wide supervision, including direct powers of the group-wide supervisor over holding companies and the oversight by this supervisor of the development and implementation of a Systemic Risk Management Plan;
- Higher loss absorbency requirements for non-traditional and non-insurance activities, which should be met by the highest quality capital. Given the absence of a global insurance capital standard, on the basis of which this measure could be applied, the IAIS was mandated to develop straightforward, backstop capital requirements for all group activities, including non-insurance subsidiaries.

The main objectives of these measures are the reduction of the moral hazard and the internalization of the externalities created by the possibility of disorderly failure of G-SIIs. They are expected to reduce the probability and impact of such failures and create incentives for the reduction of the systemic risk of G-SIIs.

² FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, https://www.financialstabilityboard.org/publications/r_111104cc.pdf

5. Consequences for Financial Stability

The generally agreed assumption underlying the development of the SIFI framework, in general, and the G-SII framework, in particular, is that by enhancing supervision of very large financial entities and introducing policy measures to tackle systemic risk, financial stability will be reinforced. On the one side, the increased cooperation and articulation among supervisors will augment their preparedness to deal with potential issues affecting systemically important institutions, decreasing the risk of their disorderly failure and the consequences thereof to the real economy. Another point to consider, more specifically in the case of G-SIIs, is the fact that the introduction of global capital standards will likely increase comparability and reduce the potential for arbitrage between different jurisdictions. This is clearly highlighted, for example, by the FSB (2013), by stating that financial stability would be supported by a sound capital and supervisory framework for the insurance sector. The introduction of the IAIS policy measures was also positive in the sense that it brought supervisors together to discuss and address the practical issues related to supervision and resolution of large cross-border insurance groups, as well as to identify the necessary powers to allow its full implementation.

However, the introduction of the SIFI framework also has the potential to introduce risks to financial stability, which should not be overlooked. It should also be noted that the designation of one institution as G-SII may reinforce its perception as being “*too big to fail*” and therefore more likely to be supported by the governments in case they face problems (FSB, 2010). There is ample literature analysing the moral hazard problem and the multiple ways in which it can manifest in the broader financial sector and, more specifically, in the insurance sector, such as Ötoker *et al* (2011), Kim (2011), Okura (2013) and Demange (2008). If the perception, by the general public, of the “increased safety” of these entities overcomes the negative impact of the competitive disadvantages introduced by the policy measures, it may also generate unintended consequences, leading to an additional growth of such entities which would even reinforce their systemic importance. This risk calls for the development of adequate and well thought policy measures, as well as close monitoring following its implementation. This leads to another risk which should be considered, the fact that the implementation of the G-SII policy measures encompasses the introduction of very significant innovations in the global supervisory and regulatory frameworks. The very short timeframe which has been defined for their development may generate risks related to the accuracy and effectiveness of the measures, in case sufficient resources are not allocated to the project. All efforts need to be developed to ensure that the policy measures, once implemented, introduce positive incentives that lead the identified G-SIIs to reduce their systemic importance, and deter other IAIGs from evolving to become G-SIIs.

Finally, it should be noted that, although the designation of G-SIIs reduced the market uncertainty about which insurance groups would be identified, there is still a very high lack of clarity concerning what will be the complete package of policy measures which will be applied to them and the impact it will generate. Higher loss absorbency and the insurance capital standard, for example, can be among the measures with greater impact, but will only be finalized by 2015 and 2016, respectively, and implemented from 2019 onwards. Uncertainty is, by definition, not a positive element in the context of financial markets. Its maintenance may lead to undesirable behaviours and consequences, which in turn create additional risks or amplify existing ones.

6. Conclusion

Systemic risk has been defined as the risk that has the potential to have serious negative consequences to the real economy. In the context of the global financial crisis, supervisors faced the materialization of systemic risk events with relevant impact on the global economy. The subsequent analysis allowed the identification of supervisory and regulatory weaknesses which permitted the build-up of such risks and, in some cases, even contributed to their amplification. In this context, a global initiative to reduce the risk posed by Systemically Important Financial Institutions has been initiated by the G20 through the FSB. After tackling the most pressing issues affecting the banking sector, the focus has now largely turned to the insurance sector. Under the mandate of the FSB, the IAIS has developed a designation methodology to identify G-SIIs, as well as a package of supervisory measures which will apply to them. Following the designation and publication of the initial cohort of 9 G-SIIs, in the summer of 2013, intense work is underway both by G-SIIs and supervisors, to fulfil the demanding requirements within the very tight timelines allowed.

Whereas the underlying assumption embedded in the G-SII work is that the initiative will contribute to the mitigation of systemic risks, there is still a significant uncertainty about the overall impact of the proposed measures. The magnitude of the work under way, the innovative character of some of the measures and the limited amount of time to complete them are among the main causes of this uncertainty. For this reason, in order to avoid the repetition of the errors of the past and their consequences to the global economy, it is of paramount importance that insurance supervisors around the world work together to ensure the delivery of a high quality set of measures, as well as their effective implementation. Only time will allow an assessment of the success of the G-SII initiative in terms of enhancing global financial stability but, as of today, it can already be classified as one of the most relevant projects of the last decades in the field of insurance at worldwide level, which will continue to dominate the international regulatory and supervisory agendas for the years to come. The natural extension of this work is the analysis, as G-SII policy

measures are implemented in the near future, of their impacts and success in contributing to the mitigation of systemic risk in the insurance sector.

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