

## “Why insurance is different to banking – getting insurers off the hook” – a look at the Geneva Association report on ‘Systemic Risk in Insurance’

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*Ash Saluja, Partner at CMS Cameron McKenna analyses the Geneva Association’s report on ‘Systemic Risk in Insurance’. This article first appeared in Complinet and has been reproduced with the kind permission of the publishers.*

There can be little doubt that the banking sector faces a regulatory revolution in the aftermath of the financial crisis. Lord Turner has a lot to say on this subject and even challenges whether some of the banking sector is socially or economically “useless”. Insurers are rightly concerned that this radical ‘get tough’ policy will spill over into the insurance sector. Many of the regulatory reforms applicable to the banking sector will be applied to insurers, but there are some key battles still to be fought.

The biggest uncertainty is the new fixation, understandably, about financial stability. The Financial Services Bill enshrines this objective in the UK’s regulatory regime and it is this factor that drives the Conservative Party’s plans to scrap FSA and move regulation of banks and building societies and, at least the larger, insurers to the Bank of England. The new vogue for macro-prudential regulation is a key part of the financial stability objective. Quite what will emerge from this black box when the economists have completed their collective head scratching is still unclear but there is talk of ever more powers for the authorities to intervene and for a host of new and more onerous regulation. One area of policy debate is the suggestion that firms that are ‘systemically important’ should be subject to additional requirements from capital and liquidity to ‘living wills’, also known as Recovery and Resolution Plans, for which the Financial Services Bill introduces a new regime which may apply to insurers as well as to deposit-takers.

Insurers are rightly concerned that although they were not the cause of the crisis, they may well suffer as the new approach to regulation is applied across sectors beyond banking. One immediate question is whether, or to what extent, the insurance sector as a whole or individual carriers, can be said to pose systemic risk. Lord Turner himself has identified potential sources of systemic risk in the sector, although he also recognised key differences between the fundamental illiquidity in banking, which lends long but borrows short, and in insurance where premia are collected and then claims paid out later. Clearly, those in the insurance sector themselves need to be asking the question as to what would be the impact of their failure on the financial system.

Useful headway has been made with the release of a Geneva Association report on ‘Systemic risk in insurance – an analysis of insurance and financial stability’. This report, produced by a leading insurance industry think-tank, argues that insurers and reinsurers are very different to banks and do not pose systemic risk, essentially for the reasons already flagged by Lord Turner. “The crisis was a crisis of the banking system, not of the insurance system, and this fact needs to be borne in mind by those developing the new regulatory architecture”. The report calculates that insurers received only \$10 billion in state support compared with \$1 trillion for the banking sector.

The essential conclusion is that none of the core activities that insurers are involved in pose a systemic risk. Not surprisingly the report does recognise the lessons to be learnt from the AIG and monoline sagas, but emphasises that these insurance groups were not brought down or threatened by traditional insurance business but by their quasi-banking activities such as CDS writing and trading and financial guarantees. It comes as no surprise that the report singles out the business of the monolines – financial guarantee insurance - for the inevitable tougher regulation. The monoline business model is often cited as a classic example of the failure of regulators to challenge the sustainability of the business model.

The report also accepts that non-core activities, specifically derivatives trading on non-insurance balance sheets and mismanagement of short-term funding from commercial paper or securities lending, have potential systemic relevance. To mitigate the potential systemic risk, the report proposes industry specific measures to enhance the regulatory regime for insurance, including enhanced principle-based group supervision and strengthening liquidity risk management practices.

According to the criteria set out to date by bodies such as the global Financial Stability Board, large insurers, reinsurers and life offices may be regarded as systemically important institutions on account of their size and ‘inter-connection’. The report, however, argues that the insurance business model – encompassing both insurers and reinsurers – is designed with features that mitigate systemic risk. In the insurance sector, unlike banking, greater size may lead to greater diversification (both geographically and across lines of business) reducing the risk posed by an insurance firm. Moreover, insurers typically become interconnected through reinsurance transactions but the effect of these transactions is to mitigate, rather than increase, systemic risk by sharing the existing risks among different parties. This is also done without undermining the

principle of moral hazard (making sure that firms do not take risks because they know they are insulated from the consequences), as the primary insurer remains exposed to a portion of the prospective loss.

The Geneva Association report uses its 'new thinking' on systemically important activities to demonstrate in turn that each of the core insurance activities does not pose a systemic risk, because they will not cause potentially large-scale losses, to insurers, capital markets and the real economy, that will rapidly materialise and be transmitted to third parties. With all the talk of 'living wills', it was crucially important for the report to draw attention to the point that insurers do not collapse in the way that banks can. Indeed, in the UK at least there were more pre-crisis failures in the insurance sector than in banking, such as Equitable Life, and none of those raised systemic issues.

In considering measures to promote financial stability in the insurance sector, the report does pay respect to the need for some regulatory reform. The Association suggests enhanced group-level supervision and sector-specific measures to strengthen liquidity risk management. It suggests strengthening risk-management practices, and supports the establishment of macro-prudential monitoring bodies but with appropriate insurance representation.

However, the report clearly lays down the gauntlet and challenges the basis for automatic read-across of banking sector reform into insurance. It is a good call to arms for the sector, which will need to keep abreast of the debate and keep arguing that 'insurance is different'.

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