FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

Insurance Sector Supervision and Crises Affecting this Sector

Selected Issues in Financial Stability

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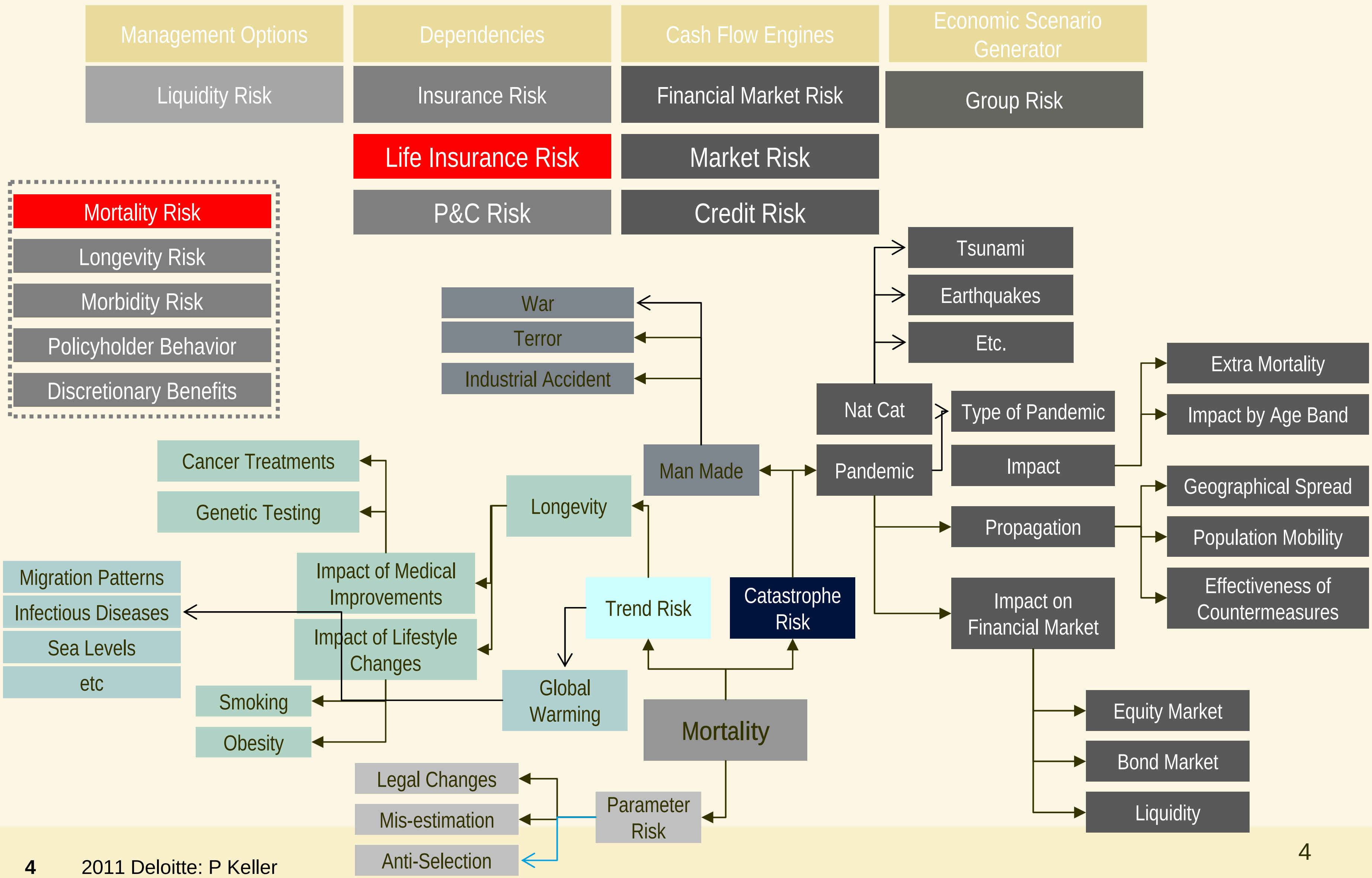
Agenda

- Insurance business model
- Insurance Core Principles
- Insurance failures, GFC and lessons learned
- Systemic relevance and macroprudential supervision
- Internationally active insurance groups

Insurance business model

- Based on pooling and diversification of risk
- Prefunded through premiums
- Insurability/probability and impact
- Residual risks managed through reinsurance, hedging, securitisation, ALM etc
- Reinsurance inversely correlated with economic cycle to a certain extent – hard and soft markets
- Insurance risk – sometimes very complex - risk accumulation, eg Hurricane Katrina, volcanic ash and Japan earthquake
- Tail risks – VaR might not be the most appropriate risk measure
- Asset-related risks also important, especially for life insurance
- Operational risk not a major risk (compare J Kerviel: 6, 7 billion, Y Hamanaka: 2, 6 billion, K Aduboli: 2 billion) - perhaps contractual risk (reinsurance of Twin Towers)
- Sophisticated modelling and used to think in scenarios (not necessarily reflected in management decisions)

Complexity of Internal Models



International standards

- Standard-setter: International Association of Insurance Supervisors (IAIS)
- Founded in 1994
- Members from more than 190 jurisdictions in over 140 countries – all regions and all types of markets
- Over 120 Observers
- Hosted by the Bank for International Settlements (BIS)

Insurance Core Principles

- **Essential elements** that must be present in the supervisory regime to promote a financially sound insurance sector and provide an adequate level of consumer protection
- **Adhered to by all insurance supervisors**, regardless of the level of development of their insurance markets, and the type of insurance products or services being supervised
- Basis from which standards are developed

Standards

- **High-level requirements** that are fundamental to the implementation of the insurance core principles and should be met for a supervisory authority to demonstrate observance with the core principles
- Written as **obligations of the supervisor**
- Linked to specific ICPs

Guidance

- **Supports the core principles and standards** and provides details on how to comply with or implement them
- **No new requirements**, rather describe what is meant by the requirement
- **Examples** of possible ways of implementing the requirements

Insurance Core Principles (revised 2011)

1. Objectives, powers and responsibilities of the supervisor
2. Supervisor
3. Information exchange
4. Licensing
5. Suitability of persons
6. Changes in control and portfolio transfers
7. Corporate governance
8. Risk management and internal control
9. Supervisory review and reporting
10. Preventive and corrective measures
11. Enforcements
12. Winding-up and exit from the market
13. Reinsurance and other forms of risk transfer
14. Valuation
15. Investment
16. Enterprise risk management for solvency purposes
17. Capital adequacy
18. Intermediaries
19. Conduct of business
20. Public disclosure
21. Countering fraud in insurance
22. Anti-money laundering and combating the financing of terrorism
23. Group-wide supervision
24. Macroprudential supervision and market analysis
25. Supervisory cooperation and coordination
26. Cross-border cooperation and coordination on crisis management

Insurance failures: HIH (2001)

- Reported 940 m $ in June 2000, failed 9 month later with an estimated deficiency of 5, 3 billion $ – was probably insolvent already in 1998
- Second largest insurer and dominated the liability classes of insurance - Australia's largest collapse to date
- Consisted of over 240 companies, of which only 4 were Australian licensed insurers
- Dramatic impact on policyholders and society
  - Unpaid claims
  - Unavailable cover
  - The state having to step in

Reasons for the failure

- Mismanagement
  - Under-pricing and provisioning
  - Creative reinsurance arrangements
- Bad corporate culture
  - Blind faith in an ill-equipped leadership consisting of dominant personalities
  - Risk not properly identified and unpleasant information hidden, filtered or sanitised
  - Lack of independence and critical analysis
- Aggressive accounting practices and lack of audit independence
- Fraud, extravagance and questionable transactions
- APRA was a new integrated supervisor with new staff and new risk-based methods

European failures (2002)

- The European Commission and 15 national regulators created a working group to take a fresh look at insurance regulation
- Analysed recent experiences of failed insurers and *near misses* across the life and non-life sector (over 20 cases from a total of 270)
- Identified the risks that had threatened firms' solvency since 1996, including how multiple risks interacted in individual cases
- Assessed existing supervisory practices on prevention and advance detection
- Unique contribution arising from the ability to study confidential information among peers

Reasons for the failures

- Underwriting and reserving risk were the main, apparent causes
- Interaction, causal links and unexpected correlations between different types of risks had not been anticipated
- However, management or governance issues were found to be the root cause (early detection)
  - Insufficient autonomy for insurers belonging to a group
  - Inappropriate experience and skills, knowledge not being up-to-date
  - Bonus policy encouraging excessive risk-taking

Great Financial Crisis - regulatory issues relevant to insurance

- Insurers weathered the crisis fairly well but were affected indirectly on the asset side (life insurers and especially in the guaranteed products)
- Banking-type operations also cause of direct losses for insurers, eg CDS
- Credit-related non-life lines more hit due to business insolvencies (including monoline financial guarantees)
- Usual demand for funds comes from claims (well-managed) but also securities lending and collateral requirements triggered by downgrade - liquidity risk management
- Gaps in the supervision of groups, eg AIG
- Life insurance: No significant increase in lapse rates due to different factors, such as loss of tax benefits
- Non-life: run is in principle not possible (claim and underlying event required)

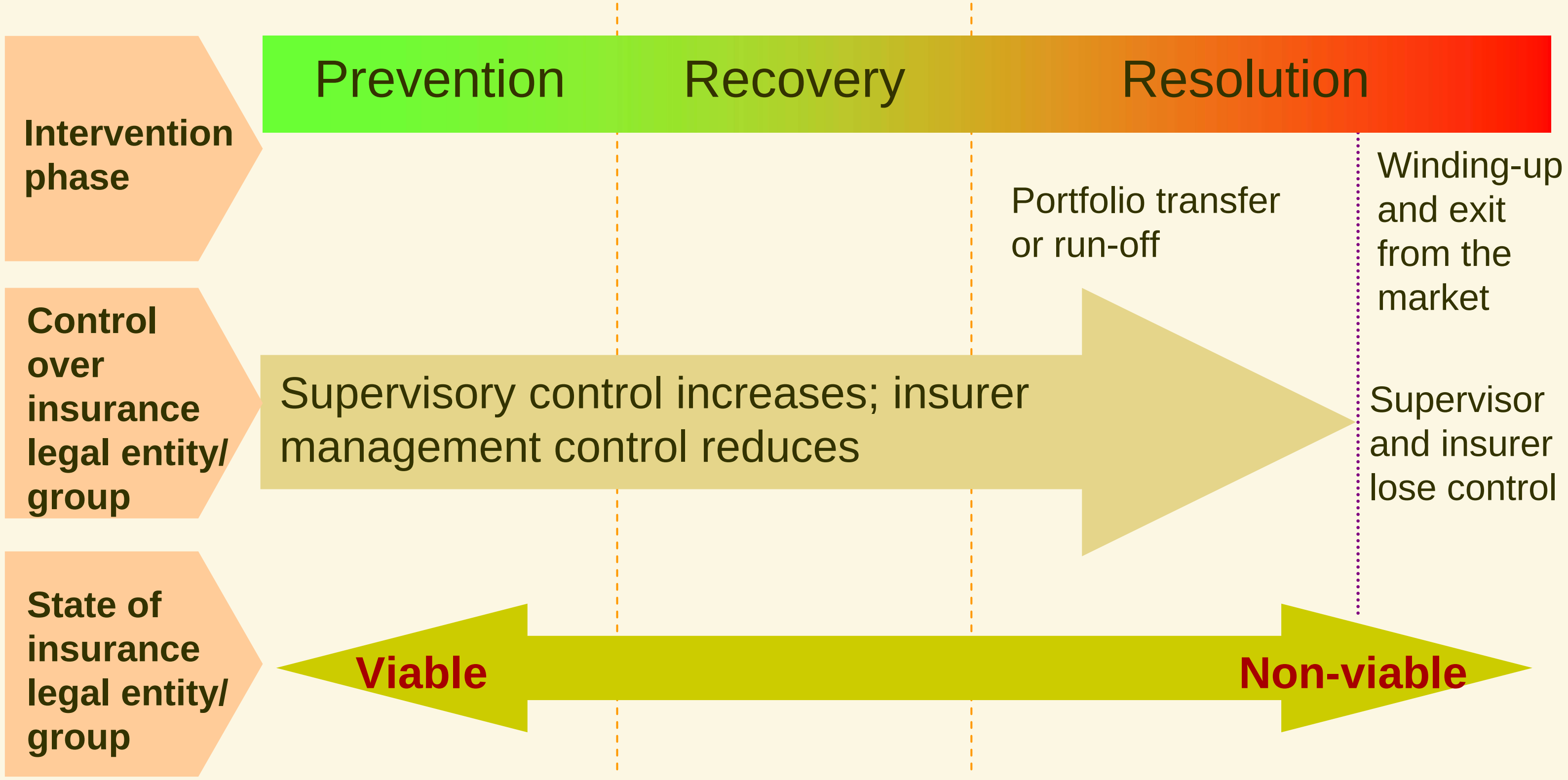
Recommendations common to the described crises

- Ability (operational independence, and adequate powers and resources) will to act (dialogue and actions)
- Build supervisory capacity and understand new risks (including insurance specific, such as technical provisions and reinsurance)
- Active early intervention
- High standards on independence and knowledge of boards, and transparency of appropriate remuneration policy
- Group supervision, including non-regulated entities
- Supervisory cooperation and colleges

GFC specific recommendations

- Identify emerging risks at the edge of the regulatory scope (unregulated entities, off-balance sheet structures etc)
- Need for macroprudential supervision and system-wide stress testing
- Continuous monitoring of internal models, not only for regulatory capital purposes
- Business models and product analysis (financial engineering)
- Higher risk management requirements for SIFIs
- Capital adequacy should reflect the underlying riskiness - risk charge also for systemic risk
- Better cross-border resolution and crisis management

Phases towards resolution



Response of the IAIS to systemic risk

- Position Statement in 2010
  - Insurers subject to systemic risk but probably not generating
  - Interdependencies between sectors may increase in the future through products, markets and conglomerates
- Developing methodology and indicators

Systemic risk in insurance?

- Standard definition: *Size*, *interconnectedness* and *substitutability*
- **Size** provides greater diversification
- **Interconnectedness** through reinsurance, however retaining more than 80 % (non-life) and 93 % (life) – diversification of reinsurers
- **Substitutability**: Market disruption due to capacity withdrawal possible but also hard markets
- Some ambiguousness in the indicators, eg size – premiums, liabilities or assets?
- Add indicator – *Time*
- **Time**: Longer timeframe available for orderly resolution (insolvency not triggering claims – not exposed to runs – portfolio transfer, run-off)
- Little evidence of insurance generating or amplifying risks except for:
  - Non-regulated entities (contagion risk)
  - Specific insurance products (financial guaranties)
  - Capital market linkages (fire sale)
- Economic importance is a wider concept than systemic importance

Response to macroprudential supervision

- Setting up a macroprudential surveillance framework
- Existing data collection:
  - Global Reinsurance Market Report since 2004, now including major direct insurers
- Mapping of key insurance risks and trends
  - Slow growth of economy – diminished expectations and less demand for insurance products
  - Low investment yields – financial instability of life insurers (Japan, now Europe and US)
  - Search for higher yields by taking higher risks?
  - Low yields also affecting non life: return on equity in 2000: 5, 9 %, 2010: 3, 5 % – coupled with soft markets and unprecedented series of nat cat (lower underwriting profitability)
- Incorporating macroprudential aspects in the Insurance Core Principles

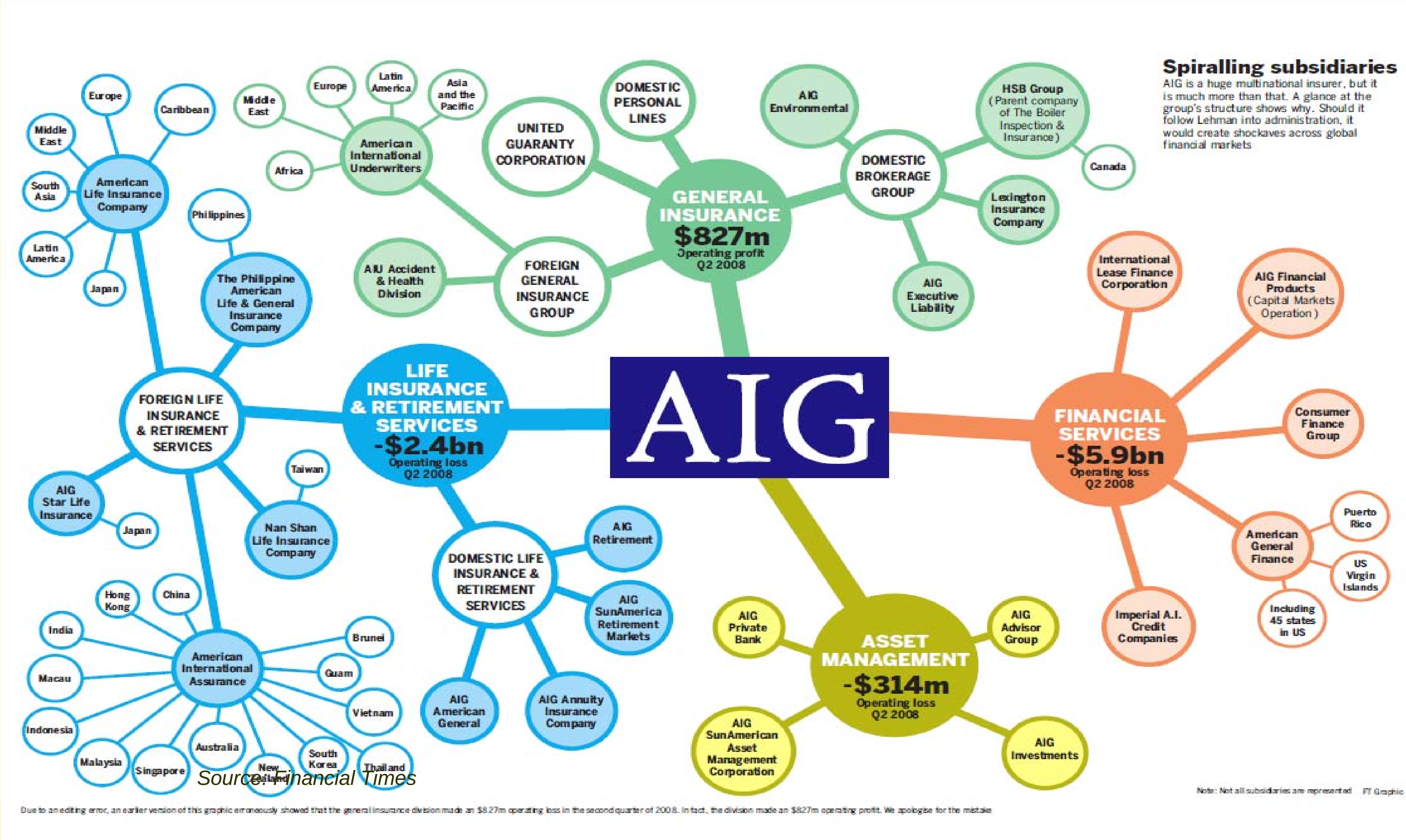
Response to cross-border issues

- **Global convergence**
  - Common Framework of Internationally Active Insurance Groups (IAIG and ComFrame)
  - Comprehensive framework to address group-wide activities and risks with more consistency and better comparability
  - Increase the number of the IAIS MMoU signatories (17+23)
  - Peer review and self-assessment, fostering adherence to IAIS Principles and Standards
- **Group-wide issues**
  - ICPs and new standards apply at both insurance legal entity and insurance group levels
  - Guidance paper on non-regulated entities
  - Issues paper on cross-border resolution
  - Reviewing effectiveness of supervisory colleges
  - IAIS Repository of Supervisory Colleges (IROSC).

Supervisory Forum

- Strengthen the effectiveness of insurance supervision
- Foster convergence of supervisory practices
- Made up of high-level senior supervisors
- Discussion on emerging and existing trends and risks
- Sharing of ideas and supervisory experiences on supervisory methodologies
- Evaluation of the potential impact of macroeconomic scenarios on large/complex groups

Large and complex group



Source: Financial Times

Conclusions

- Manage and monitor risks (including tails) – make sense of inherent risk
  - Individual firms
  - Group-wide level
  - Across geographical boundaries
  - Across financial sectors
  - Between them all
- Anticipate risks building up at all levels