PAN €UROPEAN INSURANCE FORUM

# Insurance View

## Regulatory Consequences of Financial Crisis

1. Financial crisis and regulation
2. Specificity of insurance…
3. …largely determines the impact of the financial crisis on insurers

## 1. FINANCIAL CRISIS AND REGULATION

As with previous crises the fundamental cause of the ongoing financial turmoil was an overextension of credit and a mispricing of risk. Why this happened is open for debate. The crisis has been blamed on greed, cheap money, bad underwriting, macro-economic imbalances and financial innovation. It also has been blamed on short-comings of the regulatory regime. Depending on one's view point, the finger has been pointed at a lack of regulation (or de-regulation), ill-devised regulation or over-regulation. Given the scope and complexity of this financial crisis, there is probably some truth in all of these.

We have witnessed massive government action to contain the crisis and to avoid a systemic break-down of the international financial system. As policy makers move from short-term action to sweeping reforms of the regulatory framework, it is crucial that these initiatives are grounded in sound regulatory principles and focus on systemic risks.

## 2. SPECIFICITY OF INSURANCE…

When tackling regulatory reforms, policy makers need to take into account that the business model of insurance differs substantially from that of other financial services providers. Insurers are funded by advance premium payments unlike banks, which rely mainly on short-term deposit or short-term credit funding. In most cases, they cannot be withdrawn on demand or prematurely – exceptions are certain life insurance policies. Even for life policies, there are generally early-withdrawal penalties, making withdrawal expensive and less likely. Therefore, traditional insurers are much less susceptible to – nor may they originate – a 'liquidity panic'.

In addition, insurance risks represent a high proportion of the risk profile of insurance companies. They are diversified and to a large extent, uncorrelated with market risks. The impact of a market crash is partly mitigated compared with banks where the portfolio of outstanding loans is correlated with general economic conditions.

Insurers are infrequently exposed to margin calls at times of rapid market declines, since the industry rarely uses leverage to enhance investment returns. The long-term investment horizon of insurers usually has a stabilizing effect in the market environment. Finally, insurance-linked securitization (ILS) differs from bank securitisation in the type of risk transferred, since the underlying risks are typically not financial or market risks (e.g. exchange or interest rate, credit, price) but are related to the likelihood of non-financial events. ILS has so far withstood the financial crisis.

## 3. …LARGELY DETERMINES THE IMPACT OF THE FINANCIAL CRISIS ON INSURERS

Conventional insurers entered the crisis in a comparatively strong position. The specific characteristics of the insurance business model have protected the industry from the worst impacts of the financial turmoil.

However, the insurance industry is not immune to the effects of the current crisis. The main reason is declining asset values and its effect on the value of their investment portfolios. Specific lines of business, like directors and officers (D&O) and errors & omissions (E&O) insurance, are also likely to be affected by rising claims. The sale of insurance products – in particular new unit linked business in life - is expected to fall due to the economic slowdown. With macro-economic conditions deteriorating at the global level, insurers will not be able to escape the negative consequences of recession in key markets.

Some large, complex financial companies were confronted with losses that originated in their banking divisions and have had to be rescued by governments, in common with other banks presenting a systemic risk. Financial insurance in particular bond and mortgage insurers, have correlated risk portfolios and have experienced a significant rise in credit defaults.

# 4 Policy recommendations



## 4. POLICY RECOMMENDATIONS

The financial crisis has revealed significant deficiencies in financial regulation that necessitate action above and beyond the immediate measures taken to stabilize the financial system. Insurers should be part of the debate and contribute to solutions. The regulatory dialogue should focus on the following priorities:

### 4.1 Public policies should provide incentives for sound risk and capital management

The crisis reinforces the case for Solvency II, in particular its principle-based, economic and risk-sensitive approach. The adoption of Solvency II as drawn up by the European Commission presents a big step in the right direction. Importantly, it is a holistic approach which allocates capital charges accurately to risks. The new supervisory system would also provide supervisors with the mechanisms to detect at an early stage any threats to insurers' ability to fulfil their obligations to policyholders. The experience with risk-based supervision in other jurisdictions (e.g. Swiss Solvency Test) has been positive.

Effective financial regulation has to focus on the essential and not on a myriad of detailed and technical rules. Crucially, it must create the right incentives for the proper conduct of market participants.

### 4.2 Large complex financial institutions have to be supervised in their entirety

The regulatory architecture has to be adapted to the increasing globalization of the industry.

In the US, such an upgrading in supervisory capabilities means moving beyond the state-based regulatory framework, towards a concept such as the federal optional charter.

In the EU, Solvency II offers a unique opportunity to introduce genuine group supervision, with the group support regime. It would also foster transparency and cooperation between national regulators, which is essential for the stability of the insurance industry.

At global level, group supervision should be achieved through multinational recognition of foreign supervisory activities. Regulation of non-insurance (and non-regulated) entities in insurance groups has to be addressed, especially if these entities pose a systemic risk.

More specifically, insurance groups should be able to rely on supervisory architecture that acts in a coordinated and consistent way to promote underwriting discipline and limit over-exposure to financial market risks. Global financial groups have to be supervised by colleges of supervisors, based on an allocation of responsibilities among the group supervisor and supervisors of subsidiaries in other countries. Such an evolution should not be held up by difficulties achieving cross-sector convergence.

### 4.3 Regulators must step up their efforts to achieve convergence in accounting standards

The Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB) and national regulators must step up their efforts to achieve convergence in accounting standards. It is important to avoid pro-cyclicality in accounting and prudential rules to dampen the negative spiral of the crisis. IFRS should be adjusted in order to avoid pro-cyclical effects of mark-to-market valuation of financial instruments for which there is no longer substantial market liquidity, as it has been recommended by the Chief Financial Officers Forum in its letters to the Commission and to the IASB. Subject to this, the market-consistent valuation of both assets and liabilities should become the principle that underpins financial information and prudential oversight in the insurance field. The use of a market-consistent valuation of the full balance sheet will better reflect the insurance accounts and will promote transparency.

### 4.4 Transparency regarding financial products has to be improved

Transparency is a key prerequisite not only for well-functioning markets, but also for effective regulation. Regulation of credit rating agencies should enhance disclosure requirements and avoid conflicts of interests.

The lack of information in "over the counter" trading of financial derivatives such as credit default swaps has not only facilitated the undetected accumulation of high levels of financial risk, but has also complicated regulatory intervention aimed at containing the crisis. It is therefore imperative to address opacity in "over the counter" trading of derivatives. Initial regulatory steps towards this aim would include the standardization of contracts and the creation of centralized clearing platforms.

### 4.5 Government interventions must not distort markets

There is a high risk that government interventions have unintended consequences and tilt the playing field by favouring one company over another, banking over insurance, or domestic players over group subsidiaries, both in the U.S. and Europe.
Banks with state guarantees could become under certain conditions more attractive and "trustworthy" than their competitors for customers. This could benefit their insurance activities, if any. But also those insurers that receive government support can have considerable advantages over those that have not, in a context of consolidation of the market. European State Aid rules provide the appropriate framework to monitor these risks.

Therefore, government interventions must comply with European competition rules and should be limited in time and contain clear exit clauses. There should be no discrimination in governments' plans between institutions facing the same situation, be it a bank, an insurance company, a local company or a subsidiary. The European Commission has shown itself to be flexible and pragmatic in responding to the financial crisis, recognizing that even sound undertakings may have been challenged by exogenous factors. The upcoming revision of aspects of European competition rules should draw on the lessons of the crisis.
The recent increase of the coverage of banks guarantee funds at EU and national levels is also a threat for life contracts; that should receive particular attention.

## 5. CONCLUSION: THE INSURANCE INDUSTRY HAS TO MAKE ITS VOICE HEARD

The financial crisis is likely to lead to a redefinition of the role of government in the financial services industry, at national, regional and global levels. In this process, the insurance industry has to be a credible voice to make sure that policy makers understand the distinctive features of insurance and the potentially negative consequences of hastily prepared and ill-devised intervention and regulation. A close dialogue between politicians, regulators, insurers and other market participants ensures that we draw the right lessons from the current crisis. Such a dialogue is key to ensure that reforms make regulatory systems more resilient and internationally consistent. Ultimately, any reform must act to enhance customers' trust in the insurance industry.

# Insurance View

## Regulatory Consequences of Financial Crisis

### Key Messages

* Policy makers reacting to the financial crisis need to take into account that the business model of the insurance industry differs substantially from that of other financial services sectors.

* Specifically, insurers do not generate the kind of systemic risk that arises in banking. Government interventions in support of insurance companies have to be carefully evaluated and justified against insurance specific criteria.

* As the regulatory environment in financial services is being redefined, we recommend that new legislation should be targeted, balanced, and calibrated by the expected impact it will have on the economy. It should also enhance the working of existing regulations, safeguard the level-playing field, and further enhance global consistency.

* The insurance industry has to make its voice heard. Key recommendations for policy makers are:
    - Public policies should provide incentives for sound risk and capital management
    - Large complex financial institutions (LCFI) have to be supervised in their entirety
    - Regulators must step up their efforts to achieve convergence in accounting standards
    - Much greater transparency is needed for structured financial products
    - Government intervention must not distort markets. Support may be necessary in the short-term to stabilize the financial system and support institutions but it should be subject to sunset clauses and removed as quickly as possible.

PAN €UROPEAN INSURANCE FORUM

# Pan €uropean Insurance Forum (PEIF)

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