



## REGULATING THE GLOBAL INSURANCE INDUSTRY: A COMPENDIUM OF MOTIVATIONS AND CHALLENGES

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Insurance regulators have embarked on a Herculean task: regulation of the industry on a global basis. They have two objectives: firstly, to strengthen the oversight of insurance companies that are deemed 'systemically important' in the global financial system; and secondly, to design something for internationally active insurance companies which has long since been conceived for banking, namely a global capital standard.

The work is overseen by the G20 countries and takes place under the auspices of the Financial Stability Board (FSB).<sup>2</sup> At present, the focus is on regulating insurance groups deemed systemically important. Nine groups have been identified: five from Europe, three from the United States and one from China.<sup>3</sup>

The FSB is inspired by its framework recently applied to the banking sector, where 29 banking groups were classified as systemically important. These banks were subject to a three-pronged framework consisting of enhanced supervision, the preparation of risk and crisis management plans, and the application of capital surcharges.

The regulators are pursuing a similar strategy for the nine insurance groups, and progress is underway: su-

<sup>1</sup> AXA Group and Paris School of Economics.

<sup>2</sup> There are 64 institutions that are members of the FSB; they generally include the finance ministry, central bank and the main national supervisory authority of the member countries (52 institutions in total), plus 12 international organizations including the IMF, the World Bank, the ECB, the European Commission, the BIS, the OECD and standard-setting bodies such as the Basel Committee on Banking Supervision, the International Accounting Standards Board and the International Association of Insurance Supervisors (IAIS).

<sup>3</sup> These companies are from Europe: Allianz, Aviva, AXA, Generali and Prudential (UK); from the United States: AIG, MetLife and Prudential (US); and from China: Ping An.

pervision has already been enhanced, risk management plans are under preparation, and the global community is currently working on a framework of possible capital surcharges.

The motivations are clear, but the challenges and potential pitfalls are numerous. There are several reasons why global regulation of the insurance industry is particularly challenging from both a conceptual and a policy perspective, and why it is both more difficult and more questionable than for banking.

This article presents a compendium of the key motivations for the global regulation of the insurance industry, as well as the main unresolved challenges. It explains what open questions should be addressed first, including through more research, and highlights the pitfalls of advancing regulation while some of the challenges remain unresolved. In the spirit of the long-standing OECD's ten-point checklist on regulation, the open issues concern mainly the first point on the correct identification of the problem (Box 1).

Specifically, the article argues that it would be flawed to apply a bank-based framework to the insurance industry: insurers have a different business model from banks; they have a distinctive balance sheet

### Box 1

#### The OECD checklist for regulatory decision-making

1. Is the problem correctly defined?
2. Is government action justified?
3. Is regulation the best form of government action?
4. Is there a legal basis for regulation?
5. What is the appropriate level (or levels) of government for this action?
6. Do the benefits of regulation justify the costs?
7. Is the distribution of effects across society transparent?
8. Is the regulation clear, consistent, comprehensible and accessible to users?
9. Have all interested parties had the opportunity to present their views?
10. How will compliance be achieved?

Source: OECD (1995).

structure; and, as will be shown, they interact with the financial system and the real economy in a way that is fundamentally different from banks.

**Motivations for global insurance regulation**

There are a number of motivations behind recent efforts to implement global regulation of the insurance industry, with a specific focus on large and internationally active companies. Five motivations stand out:

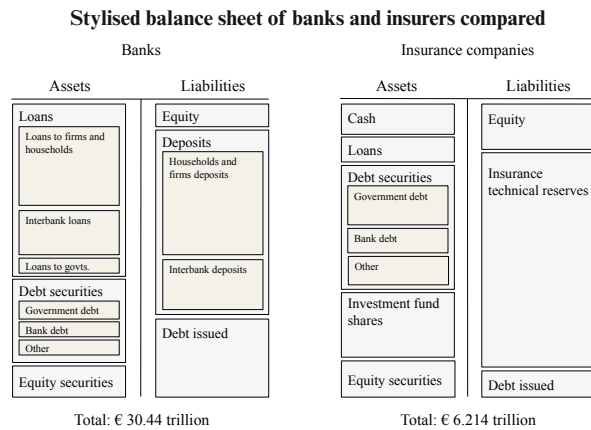
1. *Given the historic severity of the global financial crisis, only the widest possible regulation of financial institutions is politically acceptable.* The financial crisis caused the biggest rise in unemployment and the largest strain on public finances seen in the industrial world. Therefore, no policy-maker can defend the exclusion of certain financial institutions from systemic regulation. Even though some policy-makers and finance experts may be convinced of the different degrees of systemic significance of different financial institutions, and some experts have even stressed that insurance as such is not systemically risky,<sup>4</sup> such positions are not easily explained to the general public.

2. *Some insurers experienced financial distress in the global crisis and a few of them required government support.* In addition to the case of AIG discussed below, two US insurers required government support as they were particularly heavily exposed to US subprime assets; in the Netherlands, one insurer required government support for the same reason, resulting from a historic US engagement; and in Belgium, one insurer required government support because it held a significant amount of shares in Dexia bank, which lost all value in the crisis. The total support provided to these insurers amounted to about 7 billion euros.<sup>5</sup> This com-

<sup>4</sup> For example, when in the United States the Financial Stability Oversight Council decided to designate the insurer Prudential as systemic, the Council member with insurance expertise voted against this decision (“As the Financial Stability Oversight Council’s Independent Member having insurance expertise, I dissent from the final determination that, based on the analysis and conclusions presented [...], the material financial distress of Prudential Inc. could pose a threat to the financial stability of the United States” – see Financial Oversight Council, Minutes of the meeting of 19 September 2013).

<sup>5</sup> The insurance companies requiring government support included Hartford and Lincoln National in the United States with 3.4 billion

Figure 1



Note: Main balance sheet components of the euro area’s aggregated banking system and insurance sector. The size of each box corresponds to the relative weight on the balance sheet. The total absolute values also include external assets and liabilities, fixed assets, and other assets and liabilities that are not represented for the sake of simplicity. A unit-linked insurance plan is a type of life insurance where the value of a policy is linked to the net asset value of the underlying investment and where customers are allotted units, as in a mutual fund.

Source: ECB.

pares with several hundred billions of euros in support for the banking system in Europe, as well as in the United States. In the United States, the TARP programme alone amounted to 700 billion US dollars. In the European Union, state aid in the form of capital support amounted to 590 billion euros, the bulk of which was provided to the banking sector. The top three receiving banks – RBS, Anglo Irish Bank and Bankia – together received 100 billion euros in capital support.<sup>6</sup>

3. *AIG was the largest bailout in history.* This bailout reflected a conscious decision in September 2008 that Lehman Brothers could be allowed to fail, but not AIG. At the time, AIG received an 85 billion US dollar loan from the Federal Reserve and subsequently received 100 billion US dollars in support from the Treasury. It was the largest bailout of a private company in US history. This suggested that insurers were just as systemic as banks, if not more so.

4. *Insurers are large-scale financial intermediaries between savers and investors in the economy, and they are important investors in financial markets.* Life insurance products carry a significant part of national savings and provide an important source of a society’s retire-

US dollars and 1 billion US dollars, respectively; Aegon in the Netherlands with 3 billion euros, and Ethias in Belgium with 1.5 billion euros. Hartford, Lincoln, and Aegon had invested substantially in US subprime assets and Ethias had held a 5-percent share in Dexia bank that lost value. In Belgium and the Netherlands, the bank insurance groups ING, Fortis and SNS REAAL also received government support, triggered mainly by their banking operations.

<sup>6</sup> The four countries that supported their banks most with capital measures during the financial crisis were Britain (82 billion euros), Germany (64 billion euros), Ireland (63 billion euros) and Spain (60 billion euros) – European Commission (2014).

ment income. Even though the size of insurers' balance sheets in most economies is well below that of the banking sector – about 6 trillion euros in the euro area, compared with 30 trillion euros for the banking sector (Figure 1) – insurers represent a significant part of the financial system. Moreover, insurers invest in both public and private debt securities, as well as in equities, securitization and infrastructure, which are important for the functioning of the economy, for investment and job creation.

5. *Since banks, which are also financial intermediaries and financial investors, are subject to global regulation and systemic regulation, it might seem logical to apply the same principle to insurance.* There are globally coordinated standards for banks' capital, liquidity, leverage and funding ratios as part of the Basel framework. In the United States, for example, the Basel III framework is currently planned to apply to about 30 banks, with consolidated assets worth over 50 billion US dollars;<sup>7</sup> while in the European Union, the Basel III framework has been transposed into a Capital Requirements Directive (CRD IV) and applies to all 8,000 banks.<sup>8</sup>

#### Challenges for global insurance regulation

While motivations are relevant and manifold, so are the challenges for global insurance regulation. The following challenges stand out:

1. *Insurance is a less global business than many parts of banking and other financial activities, such as brokerage and asset management.* The reason is that those insurance activities that account for the bulk of assets and liabilities, namely life and savings contracts,<sup>9</sup> have their origin in providing a complementary role to social security systems that by definition vary greatly from country to country. Even though the macroeconomic situation of social security systems in advanced countries faces similar challenges, the specificities of social security systems, tax systems and habits as well as preferences for insurance differ significantly, and hence so do life insurance contracts. Contracts need national regulatory approval, and insurance competition occurs within each national constituency rather than on a global basis.

<sup>7</sup> US Federal Reserve, Interim Final Rules on the Implementation of the Basel III Regulatory Framework, 24 September 2013.

<sup>8</sup> “Contrary to other parts of the world, we apply Basel III to all our 8,000 European banks”, Barnier (2012).

<sup>9</sup> In the euro area, reserves held for life and savings contracts account for 3.6 trillion euros out of 5.1 trillion euro total reserves held for all insurance policy-holders (source: ECB, Monetary and Financial Statistics).

2. *AIG was not insurance.* The business that brought AIG down was a type of banking business, undertaken not by the insurance company of AIG in New York, but by a financial subsidiary located in London, called AIG Financial Products. Using the insurer's balance sheet and top rating by rating agencies, the subsidiary provided credit enhancements of US subprime products, mainly to banks, by selling over 500 billion US dollar worth of credit default swaps, which are not an insurance product, but a non-regulated financial product (Baranoff 2012). Moreover, the financial business in London was *de facto* unsupervised, as the Office of Thrift Supervision according to the US government commission “failed to effectively exercise its authority over AIG and its affiliates: it lacked the capability to supervise an institution of the size and complexity of AIG, did not recognize the risks inherent in AIG's sales of credit default swaps, and did not understand its responsibility to oversee the entire company, including AIG Financial Products”.<sup>10</sup> The Financial Crisis Commission concluded: “if the products sold by AIG Financial Products had been regulated as insurance contracts, AIG would have been required to maintain adequate capital reserves, would not have been able to enter into contracts without the posting of collateral, and would not have been able to provide default protection to speculators. Thus, AIG would have been prevented from acting in such a risky manner”. Hence, it was the non-insurance feature of these activities or, put differently, the non-insurance quasi-banking subsidiary within the insurance conglomerate, that caused the systemic risk.

3. *Europe and the United States – the world's two largest insurance markets – have different accounting standards.* Whereas Europe adopted the IFRS (International Financial Reporting Standards), the United States follows its national GAAP (Generally Accepted Accounting Principles) standard. The differences are significant. The same issue exists in banking, but in insurance it is compounded by different regulatory and supervisory standards (see below).

4. *Europe and the United States maintain fundamentally different regulatory standards.* Europe is about to finalise the world's most advanced, ambitious and complex regulatory standard with Solvency II. It aims to capture an economic concept of risk, provides market consistent valuations and is essentially based on market-to-market accounting. In contrast, the United States

<sup>10</sup> US government “Inquiry into the Financial Crisis Report” 2011.

maintains its longstanding risk-based capital standard, which is not a full solvency framework but seen by the regulators more as a minimum standard (NAIC 2014). The US insurance regulators are generally sceptical about an international capital standard for insurance. They are “ready to engage in the process”, but have “serious concerns about the necessity, timing and complexity of international capital standards for insurance”. Moreover, they explicitly exclude replacing the US capital framework with any international standard (NAIC 2013).

5. *There are fundamentally different supervisory standards between Europe and the United States – and even within the United States, as insurance is supervised at state level.* The most comprehensive set of financial reforms in the history of the United States that changed almost everything in regulation and supervision, the Dodd-Frank framework, changed nothing as regards the location of insurance supervision at state level. Only a Federal Insurance Office with a small number of staff was created at federal level, essentially as a monitoring and advisory function for the Treasury department. The Director of this office chairs the international forum working on a common international supervisory and capital framework, but some Congress members expressed serious concern that the Federal Insurance Office was overstepping its mandate by engaging in such international negotiations, which are seen as challenging the allocation of insurance supervision to the state level: “we are concerned that these federal agencies have participated in the development of capital standards for international insurance companies [...] and gone beyond the scope of authority granted by Congress to those entities. Time and again, the Congress has reaffirmed its commitment to preserving state supervisory authority over the business of insurance” (US Congress 2014).

6. *Systemic risk channels for insurance have not been identified.* Whereas for banking institutions the origin and propagation of systemic risk channels are well identified, both conceptually and empirically,<sup>11</sup> this is not the case

<sup>11</sup> See de Bandt and Hartmann (2000) for a pre-crisis overview; and CGFS (2010) as well as IMF (2011) for post-crisis overviews.

for insurance. For banks these three steps can broadly be described as follows:

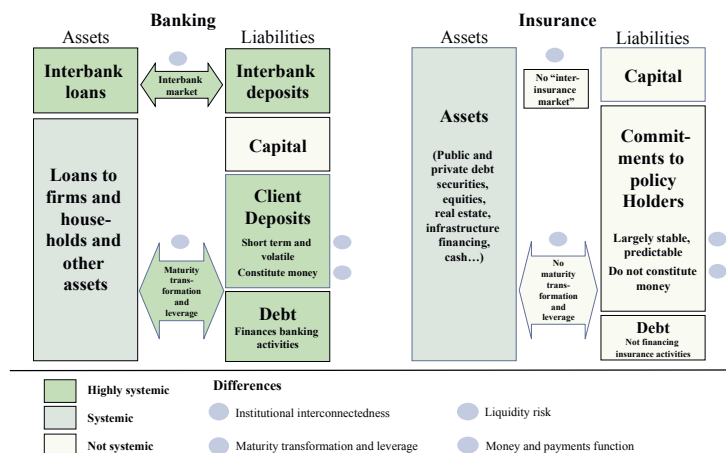
- Firstly, the primary source of vulnerability is given by the combination of fugitive liabilities, particularly deposits, including in the interbank market, combined with stickier long-term assets as a result of maturity transformation.
- Secondly, their transmission to the banking system predominantly occurs through the institutional interconnectedness to other banks that are short-term, callable at will and largely based on trust.
- Thirdly, the transmission to the real economy can occur through a combination of a fall in trust in the safety of deposits, disruptions to the payment system and/or the credit provision.

The fact that banks are financial intermediaries and investors in financial markets can aggravate the transmission of financial risk, but the importance of this aspect is dwarfed by the importance of a bank’s specific channels listed earlier.

For insurers, none of the bank-specific channels apply. Liabilities represent no means of payment, are less fugitive and mostly longer-term, assets are broadly matched and there is no ‘inter-insurance market’ as there is an interbank market with direct balance sheet exposure across institutions. The sole potential channel of transmission lies in the role of financial intermediary and investor. Here, an insurer, like any large investor facing challenges in asset management, might be able to contribute to strain in the financial system. If that is the case, the solution to containing risk may lie less in the nature of the institution than in the na-

Figure 2

**Banks and insurers: four main differences in systemic linkages**



Source: Author’s compilation.

ture and functioning of financial markets or the nature of the accounting. The issue of transmission channels of insurance-originated systemic risk is still open.

7. *The systemic interconnection of insurers is not yet well identified and is certainly different from banks.* There are four essential distinctions with regard to the systemic interaction between banks and insurers (Thimann 2014), illustrated in Figure 2.

- Banks are institutionally interconnected; they operate through direct balance sheet exposure to each other in the form of unsecured and secured inter-bank lending. These direct and important interconnections between banking institutions are an intrinsic feature of banks' operating models, and they serve as a protection against liquidity risk that is paramount in banking (Allen and Gale 2000). They establish the 'banking system' – a structure of directly interrelated parts. The fact that there is a 'central bank' further underscores to which degree banks function – and can only function – within a system. It is these institutional interconnections and their fragility that constitute the primary channel of contagion within the banking system. Insurers are not institutionally interconnected; they are stand-alone operators. There is no direct balance sheet link between the systemically important insurers. No 'insurance system', and no 'central insurer' comparable to a central bank exist. Hence, there is also no *direct* relationship of contagion among insurers as there is for banks.<sup>12</sup>
- Banks engage in maturity transformation combined with leverage; they transform short-term liabilities into longer-term assets. As returns are usually increasing with rising duration, banks have an incentive to stretch this duration gap outwards. Insurers pursue a liability-driven investment approach, trying to match their asset profile with their liability profile. As insurers can estimate the duration of liabilities, they will, in principle, seek to buy assets with a corresponding maturity, which also means that they generally can hold assets to maturity. This makes them react very differently to downward market pressure compared with a short-term funded or leveraged investor.

<sup>12</sup> It is sometimes argued that insurers and reinsurers together constitute a system that resembles the banking system. But such a parallel overlooks the functions and size of reinsurers. Reinsurers are not first risk-takers at the same level as front-line insurers, but act as a back-stop. This means that they are not transmitters, but absorbers of risk materialization. In addition, the size of the links is far from what it is in banking. Insurers only pass on a fraction of their risk to reinsurers, so that the linkages between the two levels are relatively limited.

- Liquidity risk is inherent in banking, but not in insurance. Banks risk being liquidity-short; insurers are liquidity-rich. Deposits are the largest items on banks' balance sheets. No bank has enough buffers to stem such an outflow, and systemic risk and contagion often start from liquidity shortages. Insurance liabilities are less fugitive. The liabilities for insurance of general protection, property, casualty and health are not callable at will. They relate to exogenous events that policy-holders do not influence and that are not correlated with financial market cycles. The part of liabilities that are theoretically callable concerns those parts of life insurance business that are not annuities (which cannot be withdrawn early). But there are penalties for early withdrawal, and tax benefits might vanish. In a crisis, where financial and economic uncertainty rise, it is also not evident that policy-holders would cancel life insurance policies that assure them future incomes.
- Banks deal with the payment function, they create credit and their liabilities constitute money. If the function of money, credit and payments is impaired, immediate consequences for the economy arise. Through the credit multiplier process, banks are a key component in the transmission of monetary policy impulses to the real economy, and they organise the payment function. Insurers do not create credit, and their liabilities do not constitute money, but an illiquid financial claim. Moreover, insurers are not an organisational part of the payments systems.

8. *Leverage – a key concern for systemic risk – is inherent in banking and quasi-absent in insurance.* "Banking is all about leverage", says Stefan Ingves, chair of the Basel Committee for Banking Supervision. "Banks are highly leveraged financial institutions that are in the business of facilitating leverage for others" (Ingves 2014). Leverage is the key challenge for addressing systemic risk because it creates boom-and-bust debt cycles.

Insurers do issue and hold debt but they do not do so to purchase financial assets to make leveraged returns. They do so mainly to finance mergers and acquisitions, and to a lesser extent, to establish a cash buffer if needed or to buy fixed assets (buildings, etc.). Hence, the main counterparts of insurers' debt on the asset side are goodwill, cash or fixed assets.

9. *Insurers have larger loss-absorption capacities than banks in case of crisis.* For banks, the loss absorbency

on the liability side is mostly confined to the equity tranche, and it is very challenging and potentially destabilising to raise the degree of loss absorption, especially as far as deposits, the bulk of liabilities, are concerned.

In insurance, the bail-in is built in: there is an inherent loss absorption capacity in the form of beneficiary participation, which constitutes a significant part of life insurance contracts. In these contracts, policyholders participate in the gains and losses of the investment linked to their policies. Hence, there is a built-in loss absorbency function in insurance on top of the equity tranche.

10. *The linchpin of bank systemic regulation is capital; it is not evident that this is the linchpin for insurance regulation.* For banks, higher capital requirements are effective in addressing systemic risk because, in addition to controlling leverage, they raise the costs of balance sheet growth and augment the immediate loss absorption capacity of individual institutions to shocks, which, in turn, limits the pass-through of such shocks to the system. This is the key reason why higher capital requirements are a tool for internalising systemic risk for banks. Higher capital buffers are ‘front-stop’ systemic risk.

In insurance, capital has a very different role. It serves essentially to ensure that the last policy-holder is being paid (Plantin and Rochet 2007). Firstly, all assets are wound down, which typically can take many years, and to be sure that there are enough assets to eventually also cover the liabilities of the last policy-holder under adverse market conditions, regulators demand more assets than liabilities from the outset, which is what establishes capital. Hence, whereas in banking, capital enters the sequence of adverse events at the beginning, in insurance it enters the sequence of adverse events at the end.

This difference has an important implication for systemic regulation because it changes the effectiveness of capital surcharges. Raising capital levels for banks increases their buffer to withstand shocks and helps to prevent a chain of systemic contagion. It also reduces the likelihood of adverse shocks *ex ante*, by reducing leverage, and thus the propensity to cycles of bubbles and crashes.

Raising capital for insurers, in contrast, essentially means that there are (even) more assets available to

cover the liability stream than otherwise, but such additional capital will be consumed, if at all, at the end of the process of distress and possible resolution and has no crisis prevention or stabilisation function.

## Conclusions

Insurers operate at the intersection of three circles: the economy – because managing risks is an economic task; finance – because they use financial tools to manage risks; and society – because their offerings are closely dependent on the risk and time preferences of individuals and the structure of the social system.

There is no doubt that insurers are an important component of the financial sector and that large insurance companies are both significant financial intermediaries and important investors in financial markets. There is also no doubt that they play an essential economic role, by allowing firms and households to manage economic risk. In that sense, insurers are systemically important for the economy because they provide an essential economic function.

What is less evident, and what needs further study, is the extent to which insurers can be originators or transmitters of systemic risk in the financial system – the risk that causes large parts of the system to fail. This question warrants more research into the sources and transmission channels of risk. Such research should be rooted in the business model and balance sheet structures of insurance companies, which clearly differ from those of banks.

Advancing the regulation of ‘systemic risk’ in insurance without such an explicit understanding of sources and transmission channels could end up missing the point: it might not address the right aspects and it might not use the right tools. In particular, given the different economic and financial role of capital compared with banking, it is not evident that capital surcharges would be the preferred instruments in insurance.

For example, if a potential ‘run’ on an insurer through the massive withdrawal of life insurance liabilities is an issue of concern, it is not clear that higher capital charges would prevent such a scenario; by contrast, regulation that reduces the fluidity of such liabilities by balancing individual with collective in-

terests might be a more effective option. Equally, if the holdings of bank bonds or bank equity might be a concern of insurance regulators as it induces interconnectedness, limiting such cross-holdings to avoid excesses may be more effective than demanding more capital overall.

Advancing the global regulation of insurance reflects commendable and relevant motivations. But advancing such regulation while disregarding the more ‘international’ rather than global nature of important parts of the insurance business or failing to remove important differences in accounting, regulatory and supervisory standards, especially across the Atlantic, would not achieve the aim of a level playing field. It may even aggravate distortions and create new fault lines in the present level playing fields between systemic, internationally active and national insurers.

Insurance regulators are fully aware of these issues. They should be given the time and the analysis to address them in the right way and in the right sequence. More research on the macroeconomic and financial role of insurers would be very welcome.

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