Insurance Regulation and Supervision and Financial Stability

Mexico
November 25, 2005
Insurance and Financial Stability

- Do insurance companies have an influence on financial stability?
- Can failure of an insurance company threaten that security?
- What measures are taken to prevent failure?
Insurance: an International Business

- Insurance conglomerates operate across borders
  - Failure in home jurisdiction usually means failure in all jurisdictions
- However, unlike the case for banks, we do not see substantial transactions involving flows of funds between countries
- Reinsurance is an exception
Insurance Problems as a source of Financial Crises

1997 East Asia Crisis:
- In Korea, insurance company liabilities amounted to a high percentage of retail bank deposits. Actually both were less than aggregate deposits with near-bank trust companies.

Caribbean example:
- Bank and insurance companies closely related: when public became aware of financial problems in insurance operations, there was a run on the bank.
Insurance Problems as a source of Financial Crises

In 1990’s a US based life insurance company found itself in financial difficulties because of real estate exposure

- Pensioners staged a “sit-in” in the lobby of the building – is this the insurance equivalent of a run?
Insurance Problems as a source of Financial Crises

- A property/casualty insurance company in Australia failed in 2001
  - One of the repercussions was an interruption of building construction in other parts of Asia, because the company in question was sole provider of contractor’s liability insurance.
Insurance Problems as a source of Financial Crises

- Shortly after the transition in Eastern Europe, many private banks were formed in the countries of the former Soviet Union
  - Someone got the idea that one way to reduce the capital requirements in support of the banks’ lending would be by having the loans “insured”
Insurance Problems as a source of Financial Crises

- However, insurance of the loans was obtained from special subsidiaries created by the banks.
- Program ended in disaster as both the banks and the insurance companies failed.
Emergence of an Insurance Market

- In most developing and transitional economies, insurance begins with mandatory coverages.
- This usually involves third-party motor vehicle insurance.
- Next step is the insurance of property, often started in support of bank lending.
- Insurance of lives comes last.
<table>
<thead>
<tr>
<th>Country</th>
<th>1988 Premiums as % GDP</th>
<th>2003 Premiums as % GDP</th>
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<td>South Africa</td>
<td>21.0</td>
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<td>Japan</td>
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<td>Canada</td>
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Supervisory Issues

- Control of entry and exit (implies licensing)
- Corporate Governance
- Financial reporting requirements
- Prudential rules that limit or manage retention of risk
- Minimum regulatory capital
Supervisory Issues

- Supervision/inspection/monitoring
- Power to take remedial action
- While technical details vary, many of the issues in insurance supervision have direct parallels in bank supervision
Attempts to promote best practices in supervision across entire financial services spectrum

Among other things related to the business of insurance, Forum leaders have been concerned about the working of reinsurance
Sources of Vulnerability

- Divergence in accounting, solvency and disclosure practices
- Risk management techniques that can result in an unintended aggregation of risks
- Insurance companies in some countries are direct participants in the payments system
- Growth and consolidation of reinsurance
Sources of Vulnerability

- Bankruptcy of large insurance or reinsurance company in a jurisdiction that does not have a sound regulatory/supervisory regime could have spill-over effects
- Growing interlinkages among financial industries
Industrial/Financial Conglomerates

- Regulatory arbitrage
  - Occurs when rules for different types of institutions are not well-coordinated
  - Confederation Life example involved different types of financial institutions in separate political jurisdictions

- Consolidation of capital accounts is critical
Industrial/Financial Conglomerates

- Europeans speak of “double-gearing” of capital
- Supervision must be re-engineered if it is to deal with conglomerates
- Problem is aggravated when the conglomerates involve non-financial entities
Coordination and Cooperation

- Included as a core principle for all types of financial institution – yet little compliance
- Critical importance of cooperation between supervisors of different financial industries, but also important across borders
- Confidentiality rules are an impediment
- Memoranda of understanding required
Reinsurance

- An essential part of the process: otherwise how would smaller companies serve their clients?
- As coverages increase, reinsurance quickly becomes international
- Since 1995 there has been a significant degree of consolidation and concentration in the reinsurance business
Reinsurance Experience

- Severe losses experienced by reinsurers have led to this consolidation
  - Massive losses arising from weather, product liability claims
  - Lloyds of London, formerly the leader, has undergone severe retrenchment
  - A handful of Bermuda based companies now provide the base
Reinsurance Experience

Exceptional problems such as
- Hurricane Katrina
- World Trade Center attack in 2001
Supervision of Reinsurance

- Local supervisor, such as CNSF, can influence the reinsurance practices of domestic companies.
- When those companies seek reinsurance from foreign companies, local supervisor will monitor the financial strength and claims-paying practices of the reinsurer.
Supervision of Reinsurance

- When reinsurance company appears to be an unacceptable credit, local company will be asked to post special reserves.
- Experience has shown that it is important that all reinsurance agreements be properly documented.
Supervision of Reinsurance

Unfortunately there is as yet no coordinated international supervision of the business of reinsurance.

Is such supervision a practical option?