SYSTEMIC RISKS AND THE INSURANCE INDUSTRY

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What is systemic risk?

- The risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties

- The role of confidence and trust
The probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system.

- Interdependence, interrelatedness, interconnectedness
Why the fear of systemic risk?

- Financial crises
  - 1994 - Mexico crisis and Tequila effect
  - 1997 – Asian crisis
  - 1998 – Russian debt restructuring
  - 1998 – Collapse of LTCM
  - Current flashpoints: Turkey, Argentina, Enron, telecoms, accounting, others
Fear of contagion: a financial crisis virus?

- The cross-country transmission of shocks as a result of:
  - Financial links
  - “Real economy” links
  - Political links

Result: search for systemic weaknesses throughout the financial sector
Why insurance as a source of systemic risk?

- Banking as the initial source of concern for systemic risks
  - Banking has some unique characteristics
    - High leverage
    - High potential for a run
    - High liquidity needs
    - High interdependence: lending, deposit balances, and payments clearing system
    - Last resort, safety nets, and moral hazard
Cont’d

- Banks as key participants in large-value payment systems
- Securities firms as key participants in clearing and settlement systems for globally-traded securities
- From banking, securities, and insurance firms to financial services firms
- All financial institutions are potential sources of systemic risks: Insurance and reinsurance as sources of systemic risk
# TOP FINANCIAL FIRMS BY MARKET CAPITALIZATION

(Source: The Economist, May 18, 2002, Survey of international finance, p.6)

<table>
<thead>
<tr>
<th>1990</th>
<th>2001</th>
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<tbody>
<tr>
<td>1. Industrial Bank of Japan 57.1$bn</td>
<td>1. Citigroup 259.7$bn</td>
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<td>2. Fuji Bank 52.0</td>
<td>2. American International Group 207.4</td>
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<tr>
<td>3. Mitsui Taiyo Kobe Bank 46.3</td>
<td>3. HSBC Group 109.7</td>
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<td>4. Sumitomo Bank 46.0</td>
<td>4. Berkshire Hathaway 100.2</td>
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<td>5. Dai-Ichi Kangyo Bank 44.8</td>
<td>5. Bank of America 99.0</td>
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<tr>
<td>6. Mitsubishi Bank 44.0</td>
<td>6. Fannie Mae 79.5</td>
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<tr>
<td>7. Sanwa Bank 41.2</td>
<td>7. Wells Fargo 73.7</td>
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<tr>
<td>9. Long-Term Credit Bank 24.8</td>
<td>9. Royal Bank of Scotland 69.4</td>
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<td>10. Allianz 24.6</td>
<td>10. UBS 67.1</td>
</tr>
<tr>
<td>12. Mitsubishi Trust &amp; Banking 17.2</td>
<td>12. Morgan Stanley Dean Witter 61.4</td>
</tr>
<tr>
<td>13. Deutsche Bank 16.4</td>
<td>13. Lloyds TSB 60.3</td>
</tr>
<tr>
<td>15. Bank of Tokyo 15.9</td>
<td>15. Credit Suisse 51.3</td>
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So what about insurance and reinsurance as potential sources of systemic risks?

- **Convergence and the passing of risks around the financial system: reinsurers and credit risk**
  - Are they as skilled at diversifying and transferring as they think?
  - Are they capable of managing the risks transferred to them?
  - Do they understand the new risks?
Cont’d

- The “too big to fail” situation
- Exposure to extreme events, legal risks, and the settlement process
- Retrocession spirals
- Investment portfolios: derivatives, leverage, and liquidity
- Off-balance sheet transactions
- Importance of intangible assets
Guarding against systemic risks

- Capital requirements
- Crisis prevention policies
  - Coordination and exchange of information
  - Improve incentive structures
  - Minimization of moral hazard
  - Transparency and disclosure
  - Liquidity backstop facilities
- Reforms
But remember…

“When you hear the government talking about systemic risk, hold on to your wallet! It means that they want you to pay more taxes for more regulations, which are likely to create systemic risk by interfering with private contracting…In sum, when you think about systemic risks, you’ll be close to the truth if you think of the government as causing them rather than protecting us from them.” Fisher Black, (1995) *Hedging, speculation, and systemic risk*. Journal of Derivatives 2:6-8.