

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

Insurance Penetration (Premiums as % GDP)

1988

- South Africa 21.0
- South Korea 14.0
- Switzerland 12.7
- Japan 12.0
- United Kingdom 12.0

2003

- South Africa 15.9
- South Korea 9.6
- Switzerland 12.7
- Japan 10.9
- United Kingdom 13.4
- USA 9.6
- Canada 6.8

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

Financial Stability Forum

- 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?