Why Insurance in General and Reinsurance in Particular are Not Systemic
By Denis Kessler*

This article summarises and complements an article by Denis Kessler to be published in The Journal of Risk and Insurance.¹

The traditional model of (re)insurance lacks the elements that make a financial institution systemically important. (Re)insurers that have stuck to this traditional business model have successfully weathered the crisis, even playing a stabilising role. Unfortunately, this is not sufficiently recognised in the current debate on assessing systemic risk in the (re)insurance sector, and the FSB recently designated nine insurers as “systemic”. While it plans to assess the systemic nature of reinsurance by next year, it is important to dispel ill-founded fears.

By their very nature, (re)insurer failures pose very limited systemic risk
The failure of a (re)insurer is a relatively rare event and, when it does actually occur, it poses very limited systemic risk.

The main reason explaining why (re)insurer failures rarely spread to the rest of the financial and economic system is the way in which (re)insurers fail. The failure of an insurer is, in general, an orderly and lengthy process that stands in sharp contrast to a typical bank failure. A failing (re)insurance company does not interrupt its contracts overnight, but continues to settle its claims. In most cases, the portfolio is sold to another (re)insurer, as multiple buyers can generally be found easily and quickly. Claims continue to be settled in an orderly manner. The length of the process, along with regulatory provisions, cause supervisors to intervene early on in the process, in order to protect the policyholder.

Another crucial point is that the settlement of claims is guaranteed by the (re)insurer’s assets. Regulatory requirements and core professional practices compel (re)insurance companies to hold assets of sufficient quality and liquidity to match cash outflows generated by the company’s liabilities.

Furthermore, liabilities are not redeemable on demand like bank deposits, but require a triggering event, the probability of which is independent of the state of the economy—earthquakes are not more frequent in a recession, for example.

More importantly, claims can normally be paid by asset sales, since the maturity mismatch is limited, compared to that generally found in banking. This is mainly because an insurer’s core business does not involve maturity transformation, in contrast to that of a traditional bank.

Moreover, in some jurisdictions, a proportion of assets must be “tied” so that they are invested securely, in amounts that precisely match the reserves.

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(Re)insurers tend to diversify rather than concentrate risks

The essence of (re)insurance is to diversify risk, through risk sharing and other mechanisms: a (re)insurer’s portfolio consists of a large number of uncorrelated risks to keep simultaneous pay-outs at a minimum. The benefits of risk sharing are amplified by diversification with risks taken across a wide variety of countries, sectors and types of policyholders.

Finally, insurance pools cover exceptional risks such as nuclear catastrophes, terrorist attacks and environmental liability. Claims triggered by these exceptional events are shared by all members of the pool, with governments often providing guarantees above certain thresholds.

(Re)insurers keep most of their risks on their balance sheet

In (re)insurance, risks are kept in general on the balance sheet: there is very little moral hazard generated by the dissociation of origination and distribution activities that has recently bedevilled many banks.

One should bear in mind that reinsurance/retecession always involves only a partial cession of risk, with an average of more than 90 per cent of the risk staying on the ceding (re)insurer’s balance sheet. Consequently, (re)insurers carefully and thoroughly screen each and every risk before accepting it.

Those insurers who did have material off-balance sheet exposures were actually undertaking banking activities, such as the writing of credit default swaps (CDSs) for speculative purposes. Some observers might object that the growing use of derivatives by the profession could have destabilising effects. However, this argument misses an essential difference in the way banks and (re)insurers use derivatives, in that many regulators tend to provide (re)insurers with a powerful incentive to use derivatives for hedging purposes.

- **The nature of “leverage” used by (re)insurers in their core activities does not create systemic risk**

Traditionally, banks are highly-leveraged institutions. They finance their assets by borrowing from the markets (investment banks) or from depositors (commercial banks). This makes them particularly vulnerable to crises of confidence. In such cases, a bank has to liquidate its assets at a price potentially well below their fundamental value.

To a certain extent, (re)insurers could also be considered as leveraged institutions. Their assets are only partially self-funded, inasmuch as the bulk of their funding comes from reserves. However, contrary to deposits and wholesale market funding, reserves are not instantaneously puttable and thus cannot be redeemed on demand by policyholders.

Of course, this is not really the case for life insurance, which may be viewed under some circumstances as a savings product with puttable features. However, many mechanisms limit the extent to which a life insurer could experience a sudden and massive withdrawal of funds. Moreover, reserves are usually longer term than the inter-bank or wholesale market liabilities typically used by banks.

- **There is very little liquidity mismatch in core (re)insurance activities**

The very nature of (re)insurance ensures that there is very little liquidity mismatch. By contrast, banks, which borrow short term and lend long term, are extremely vulnerable to market liquidity suddenly drying up.

The story is totally different in the case of (re)insurers. The maturity of their assets usually closely matches that of their liabilities: (re)insurers have a long liquidity position.

- **The traditional (re)insurance model passed the recent crisis stress test**

Thanks to the strengths of its traditional business model, the (re)insurance industry weathered the financial crisis of 2007–2010 with far greater success than other financial institutions.

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It should be noted that the insurers that did suffer significantly during the crisis had business models widely different from those of traditional insurance. More than 90 per cent of public rescue funds devoted to the U.S. insurance sector were channelled to insurers with material banking activities.\(^3\)

Another breed of insurers, the monolines, also paid a high price for deviating from the traditional model of risk diversification. Monolines insured undiversified and highly leveraged credit risk portfolios, which were concentrated on structured products, i.e. miles away from the traditional (re)insurance business model.

In contrast to the above-mentioned specific categories of insurers, (re)insurers with traditional business models incurred limited losses and played a stabilising role in the crisis by maintaining positive asset investments.

**Reinsurance in particular is by no means a systemic threat—instead, it has stabilising virtues**

Reinsurance and retrocession have an overall stabilising effect on the insurance industry by shielding insurers from financial difficulties when large losses occur.

Of course, reinsurance and retrocession introduce some interconnectedness among insurance institutions. Since systemic risk usually arises from the propagation of localised shocks to the rest of the financial system through interconnectedness, regulators might focus on reinsurance when addressing systemic risk. However, reinsurance and interbank interconnections widely differ by nature. In the interbank market, risk is strongly concentrated due to a network of very short-term, bilateral exposures, which are significant compared to bank equity.\(^4\) Hence, the failure of a single bank can generate multiple bankruptcies. Most banks are indebted to the very same banks to which they have granted loans. Thus, when a single bank or group of banks fail, other banks may fail in turn, which creates a downward spiral of losses.

The structure of the (re)insurance market is different. It is hierarchical, in the sense that primary insurers cede a single risk to many other reinsurers, which in turn often cede it to different retrocessionaires. But insurers and reinsurers do not usually take back the risks they have ceded. Feedback loops, wherein reinsurers pass a single claim back and forth, thus amplifying its original size, tend to be extremely rare.\(^5\)

For that matter, reinsurer failures also tend to be rare events. In the last 20 years, while several major natural and man-made disasters have occurred (9/11, Katrina), the reinsurance industry has proven its high resilience. What is more, when a reinsurer fails, portfolios are usually sold to other reinsurers, thereby preserving the cover offered to insurers.

Thus, a reinsurer’s failure rarely triggers the default of primary insurers. During the period spanning 1969–2009, only 3.2 per cent and 2 per cent of the financial losses of direct non-life and life insurers, respectively, were caused by reinsurance failures.\(^6\) According to a recent study by the *Autorité de contrôle prudentiel* on the French market, the simultaneous failure of all reinsurers would not entail the failure of any insurer.\(^7\)

**Conclusion**

There is a legitimate desire on the part of regulators to prevent a recurrence of the kind of systemic event we experienced a few years ago. However, putting (re)insurers in the same basket as banks and other financial institutions is misguided, since neither insurance nor reinsurance companies create significant systemic risk, provided they operate within their traditional business models.

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\(^6\) Ibid., p. 12.

In the methodology regulators have developed, too much emphasis is likely to be placed on the absolute size of institutions. This is a problem because what actually generates systemic risk is not size per se but *undiversified size*. Aside from the shortcomings of this methodology, designating systemically important insurers is counterproductive because it constitutes an obvious source of moral hazard. The market may consider that institutions declared as G-SIIs have received a “bail-out certificate”, thus providing an incentive to take unreasonable amounts of risk. Such institutions might also benefit from a “flight-to-quality effect” which might increase their size still further compared to the rest of the market. Instead, the focus should be placed on better monitoring of non-core activities and on increased cooperation between regulators.

This is true for insurance companies as well as for reinsurers. The fact that the FSB has postponed the decisions on reinsurance to 2014 is testimony to the fact that reinsurers do not pose any acute or urgent risk to the financial system. Regulators should use this additional lead-time to rethink their approach through an ongoing, in-depth dialogue with the industry.