If reinsurers are not systemic, who are?

The debate on whether insurers can be systemically important has taken a strange turn. After focusing on non-traditional and non-insurance activities at large international insurance groups, the scrutiny is now on whether or not to include reinsurance groups into the set of systemically important insurers. Lobbyists are rumored to have found the weakest link at the FSB (this time the USA) to stop reinsurers from being considered as systemically important. The arguments for this remain unclear. The main reinsurers are big, their clients depend on them, and if they have to liquidate their assets to afford a timely payout this would impact on the financial markets.

In the past, arguments appeared to focus on the expectation that the problems would be dampened by the structure of the insurance market. A regular insurer stands between them and policyholders, which would continue to be liable even if the reinsurer on which it relied fails. A traditional argument is also that reinsurance is more like traditional direct insurance instead of like non-traditional insurance activities such as derivatives investing. If such reasoning would be considered valid still, that would be shortsighted, but not unexpected. Reinsurers, insurers and the IAIS have a track record of downplaying potential contagion arising in the insurance sector, including in the reinsurance sector.

Reinsurers are not client-facing, that is true. And the policies they close are not structured as formal derivatives, but as insurance policies of a direct insurer against the materialization of a risk (in their case, that policyholders make claims at the direct insurer). If a reinsurer fails, the direct insurer is indeed left holding the bag. However, that direct insurer would have a huge gap in its capital and technical provisions. A reinsurance contract counts as risk mitigation for prudential supervision purposes at the direct insurer. If the reinsurer can pay out, it does indeed mitigate that risk by offering to pay all or part of the claim that arises from a policy written by a direct insurer (in exactly the way derivatives do if the triggering event occurs). The direct insurer subsequently does not need to hold financial buffers for potential claims that are no longer expected to land on its balance sheet as it is expected to be reimbursed in full by the reinsurer. For large reinsurers this (large) gap at the direct insurer it contracts with is multiplied across all the direct insurers it accepted premiums from. If one of them makes a disproportionally large claim, the reinsurer may no longer be able to honor its commitments to other direct insurers, making reinsurers the main potential channel for contagion in the insurance sector. As e.g. mortgage loans are built on required fire insurance and long-term pension payments from life insurance policies, this would impact on the banking sector too, providing another channel for systemic risks. Even if reinsurers can delay the pay-out by denying the validity of claims, that would just speed up the problems at the direct insurers and their clients, and would not dampen market expectations of asset sales by the reinsurer for an eventual pay-out.

The limited set of large reinsurers are thus a crucial underpinning of this sector of the financial market, similar to the role of central clearing parties (CCP) in securities trading, and ECB systems in Eurozone payment systems. The argument a non-client-facing entity is not systemic has been (and should be) eradicated from public policy thinking since the AIG London branch, LTCM and the Fannie Mae/Freddy Mac bail-outs. Even shareholders of large reinsurance companies like the subsidiaries of Berkshire Hathaway should actually see the benefit of better focus on and the acknowledgement of the importance of such key service providers. For one, it makes their investment in a reinsurance company less likely to suffer catastrophic damage. And if reinsurance would get a more explicit systemic role as a stimulated safety buffer for the wider insurance sector (like CCP's and depositaries are for the securities markets), it would actually be a business opportunity. It would strengthen their hand against competitors from the hedge fund industry or (other) derivative writers. Even so, it would be more likely that shareholders and boards of reinsurance companies would actually admit that reinsurance is systemic, if the consequences of being deemed systemic were more focused on the business at hand. This is now not the case. The FSB and the committees that work for it (such as the IAIS) appear focused on just slapping an extra percentage on a yet to be developed solvency ratio for large worldwide operating insurers, in a move copied from the banking sector. The fact that it is not yet tested there as an effective tool to avoid or even mitigate a banking crisis does not seem to dampen regulatory ardor to roll it out to non-banks, but it may dampen the ardor of shareholders and boards to subject their reinsurance companies to it.

They have a point. To me it appears strange that the systemic surcharge on top of a debatable ratio calculation is now copied in other financial sectors as if it is a wonder formula. Especially if there is little or no experience with a solvency ratio in the insurance sector in the first place (where a first solvency ratio under the EU Solvency II directive is being rolled out only now). It is not guaranteed that a higher percentage for systemic insurers based on a totally new formula for calculating a ratio would withstand (fear of) the potential waves of destruction of a next crisis, nor that it would avoid the pitfall of being calibrated to the last crisis instead of to the next.

It may be better for the FSB and the (re)insurance industry instead to come up with a more measured response, focused on what is known to work in the specific financial sector at hand. For instance, CCP's have a similar role in the securities sector both as a core service provider, risk mitigator for client facing securities firms, and – because they are trusted to handle this – risk aggregator as reinsurers have in the insurance sector. CCP's developed homegrown techniques to be able to bear that risk, mainly by a system of collateral (margin), guarantee funds and novation and netting through which risk is minimized and spread. If reinsurers de facto are relied on in the insurance sector to play a risk-mitigating role and want to be trusted to be a risk aggregator, they should equally develop or expand risk-mitigating techniques. If reinsurers ask legislators to rely on the insurance they provide to direct insurers – which does appear to be part of their business model – they could embrace this role in a proactive manner by mitigating such aggregation/concentration risks. It should not be necessary to assume that each can withstand a multiple of risks arising at the same time, it should be certain. In other words: if reinsurers would like policyholders, direct insurers and supervisors to embrace a core role of reinsurers, it becomes more important that they are bankruptcy remote.

Learning from the CCP example and from what has worked well in the insurance sector, it might be good to take a second look at the benefits of solo supervision and the assets reserved for the calculated technical provisions (i.e. the calculated maximum potential pay-out under open policies). Instead of relying on untested new solvency ratios – even if they are calibrated to be higher for systemic entities – a better response to a systemic reality would be to rely on a combination of:

- more conservatively calculated technical provisions for the maximum potential pay-outs under the reinsurance contracts they have written;
- segregated assets for those;

- collateral rights held by the collective of (policy holding) direct insurers on those segregated assets;
- with a clear pay-out schedule that guarantees equal treatment of various current and future claims;
- and perhaps a mutual guarantee system if overwhelming claims arrive at a reinsurer.

Also see:

- Buffett clout brought to bear in rules fight, FT 14 October 2015 (published under different title on ft.com on 13 October 2015).
- EU Banking Supervision, chapter 6.2, 6.5, 19.4 and 22.
- Are EU Banks Safe?, chapter 4.5.
- FSB, 2014 update of list of global systemically important insurers (G-SIIs), 6 November 2014.
- IAIS, Reinsurance and Financial Stability, 19 July 2012.