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Are (Re)Insurance Operations Source of Systemic Risk?

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The notion of systemic risk has been used for a long time by economists and central bankers in relation to the notion of "lender of last resort" played by governments and more especially central banks in order to support banks in case of the most extreme financial crisis that may endanger the whole financial system and that require an outer solution, i.e. a solution that cannot be provided by the endangered system.[1] Rigorously speaking, systemic risk refers to systemic failure, i.e. to the failure common to an entire system; it is the financial system or the market or the whole economic system including the government. The extent to which systemic risk affects markets, however, is positively correlated with the markets and cannot be diversified away by the markets, justifying therefore a State intervention.

Much of the economic and financial literature has focused on the danger that problems in a single financial institution, more precisely in a bank, might spread and, in extreme situations, such contagion could disrupt the normal functioning of the entire financial system. Systemic risk points therefore to a double market failure: firstly, the inability of the market to always clear efficiently and stop contagion; secondly, the inability of the market to deal with the biggest aggregate risks. Of course, size, interconnectedness, substitutability, leverage, liquidity, large mismatches and complexity play an important role but they are not sufficient conditions for defining a systemic risk as outlined above; they need a further condition, which is the threat of a collapse of the entire system. The systemic risk is by nature a macro-economic risk, not only because it threatens the whole financial and/or economic system, but also because it is worldwide.

According to the above definition of systemic risk, banking operations have always been considered as a source of systemic risk when (re)insurance operations have not been for the following reasons:

- Extreme events covered by (re)insurance, such as pandemics or terrorist attacks, may be systemic but this systemic dimension is due to the nature of the event not to the nature of the operation, i.e.(re)insurance, or to the eventual collapse of a (re)insurance company.
- Compared to banking operations, (re)insurance operations are only weakly exposed to liquidity risk, which has historically been at the core of systemic risk; because of the viscosity of (re)insurance liabilities and because of their inverted production cycle the liquidity constraint on (re)insurance operations is tenuous.
- (Re)insurance operations do not need indebtedness, which is at the core of systemic risk and banking operations; of course, some (re)insurance companies may end up with an excessive debt financing. But this does not result from their insurance operations, rather from their quasi-banking operations.

[1] See Jean-Charles Rochet (2008) *Why are there so many banking crisis?,* Princeton University Press, New Jersey, Xavier Freitas and Jean-Charles Rochet (1997) *The economics of banking,* MIT Press, and Louis Eeckhoudt, Christian Gollier and Harris Schlesinger (2005) *Economic and financial decisions under risk,* Princeton University Press, New Jersey. The "lender of last resort" concept has been firstly presented by Bagehot but prepared before by Thornton.

- (Re)insurance operations are on-balance sheet operations; securitised (re)insurance risks remain inside the balance sheet of the initiator; portfolio transfers need supervisors' agreement; of course, some (re)insurance companies may end up with a lot of off-balance sheet exposure but this does not result from their (re)insurance operations, but rather from their quasi-banking operations.
- More generally, monoliners and credit derivative activities, which clearly incorporate systemic risk, resort to quasi-banking operations and not to (re)insurance operations.
- (Re)insurance operations present a limited exposure to the risk of contagion; of course, the spiral of reinsurance may interconnect many actors of the reinsurance industry but it represents only 13 per cent of insurance premiums and it is not a short-term business, as opposed to interbank credit activity.
- Furthermore, the concept of *bank*ruptcy, which plays a key role in the propagation of systemic shocks, does not apply to (re)insurance that resorts to *run off* where contracts are not interrupted but cleared over many years according to their duration.

If, according to the above definition of systemic risk, (re)insurance operations are not sources of systemic risks, they may well be victims of systemic risks and, as a consequence, propagators of it. The situation of (re)insurance with the regard to the potential damages of systemic risk is not homogeneous:

- Life insurance that covers long-term commitments with congruent assets is less exposed than banking to these potential damages.
- Non-life insurance that works essentially on real risks is less exposed than life insurance to them.
- Reinsurance that works more on stocks than insurance is itself less exposed than non-life insurance.
- Finally, inside reinsurance, life reinsurance that works more on fixed amount of capital is less exposed than non-life reinsurance.

Compared to this economic definition of systemic risk, as systemic collapse, the FSB implicitly relies on a looser definition when assessing the systemic relevance of financial institutions. It identifies systemic risk with risk of shock of severe nature, i.e. risk that an economic shock, such as a market or institutional failure, trigger either a chain of the financial failure or a chain of significant losses to financial institutions, resulting in a dramatic increase in the cost of capital or decrease in its availability. Of course, the FSB distinguishes systemic risk from downturns that are caused by normal market swings and from large financial failures. Under the stricter definition of systemic risk, there is no scope for it emerging out of insurance companies.

According to the implicit definition of systemic risk used by the FSB, (re)insurance companies may carry out some activities of a quasi-banking nature that could be a source of systemic risk if carried out massively, without proper risk control and inadequate supervision, as analysed in the report *Systemic Risk in Insurance* by The Geneva Association. However, this dimension of activities could readily be regulated. At the same time, supervisors should be cautious and balanced when regulating (re)insurance companies because (re)insurance operations are not able to endanger the entire financial and economic system, as opposed to banking and quasi-banking operations.

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