Review of Systemic Risk of Insurance Company

The market failure from 2007 global financial crisis from systemic risk drew our attention to the regulation of systemic risk in banks and the concept of Systemically Important Financial Institutions (SIFIs) was introduced from the Dodd-Frank Act in the United States.

The argument of applying the same level of systemic risk regulation to insurance companies became more convincing after the financial failure of AIG made the entire financial system highly vulnerable. The conventional wisdom of the systemic risk of insurance companies indicates no systemic risk in insurance business unlike banks due to their insensitivity to macro-economic variables, less exposure to financial risks, possible diversification of unsystematic risks and no issue of insurance run. However, the decision of Financial Stability Board (FSB) to designate 9 insurance companies as Globally Systemically Important Insurers (GSII) after the AIG bailout ended any argument on the existence of systemic risk in insurance companies.

This report investigates the academic findings on the definition of systemic risks, application of systemic risk approach developed in banking industry to insurance industry and discusses some relevant issues on the systemic risks of insurers. The increasing importance of considering and recognizing those issues guarantees the value of thorough understanding and analysing systemic risk in insurance sectors.

Most research in systemic risk of insurance companies and insurance industry can be summarized into the following ten issues. First, both financial institutions and financial transactions must be analyzed for the systemic risk. Second, risks, causes and consequences of events are primary elements of systemic risk. Third,
both micro- and macro-prudential issues are considered simultaneously. Fourth, systemic risks of insurance consist of traditional insurance function such as underwritings and other functions such as investment as well as financing activities. Fifth, most well-known findings tell traditional insurance function is associated with other financial sectors in terms of their correlations. Sixth, non-traditional insurance function such as insurance products embedded with options, financial guarantees and credit derivatives creates systemic risk and make the industry vulnerable to the risk. Eighth, non-traditional investment and financing functions such as securities lending and credit rating utilization increases the liquidity risk of insurers. Ninth, the liquidity constraint and high vulnerability of insurers may cause the systemic risk from lack of liquidity in the global insurance groups. Tenth, higher level of insurance regulation, reasons for additional capital requirements and the market discipline should be discussed for regulation of systemic risk in insurance sectors.

The arguments of criticizing insurers are the cause of systemic risk has not been strongly supported until the 2007 financial crisis and the failure of AIG. Now the new approach for the systemic risk in insurance industry emphasizes the fact that there should be a systemic risk if any capital constraint by insurers or any part of financial system contributes the risk of the financial system. We know the risk of AIG became very much contagious and the asset sales of financial distressed financial institutions create risk in the system. This reports shows we have the evidence for the existence of the systemic risk in insurers and insurance industry and we need to expand our discussion into traditional insurance functions as well as non-traditional investment and financing functions performed by insurers.