

# Financial stability and insurance – Why SME insurers should raise their voices

**Dr Kai-Uwe Schanz**, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, reviews the discussions on potential risks to the financial system posed by the insurance sector and encourages CEOs of SME insurers to make their voice heard in this pivotal debate.



So far, the insurance industry has largely escaped the radical regulatory backlash many feared would hit as a result of the financial crisis of 2008 and 2009. Admittedly, insurers and reinsurers, primarily in Europe, are busy preparing for a new and more onerous regulatory environment calling for risk-based solvency capital, improved risk management processes and broader and deeper risk disclosure. But most of these initiatives have been set in motion prior to the financial crisis.

More intrusive regulations constraining insurers' fundamental entrepreneurial degrees of freedom (such as specific restrictions on business models) are currently off the political and regulatory agenda. For the very first time, (re)insurers' collective messaging efforts seem to have proven effective on a truly global scale, not least orchestrated by its highly visible leading think-tank, The Geneva Association.

## Why insurers are different

Let us revisit the industry's key messages before explaining why it should not rest on these laurels and, in particular, why CEOs of SMEs should increase their share of voice. It is generally accepted that banks and insurers have played markedly different roles in the financial crisis:

- Insurers did not cause the crisis nor were they in need of major public bail-out funds, except for a number of players who 'indulged' in quasi-banking activities.
- The insurance business model has specific features that make it a source of stability, and not instability, in the financial system. Most importantly, insurers are funded through up-front premium payments. In general, outflows do not depend on the will of the insured. Therefore, any notion of an 'insurance run' is misconceived.
- As opposed to banks, insurers did not lend to each other in any major way and, therefore, are not to blame for the 'near-infarct' suffered by the global financial system when trust between banks evaporated and interbank lending grinded to a halt.
- The few insurers who experienced serious difficulties were brought down by quasi-banking activities, not their core insurance business.
- Only two non-core activities of insurers have the potential for systemic relevance: derivatives trading on non-insurance balance sheets and mismanagement of short-term funding from commercial paper or securities lending. These risk factors must and can be mitigated.
  - In contrast to what we have seen in the banking sector, the liquidation of an insurer is an orderly process that does not generate systemic risk.

## Why SME insurers should step up their involvement in the debate

Based on this set of key messages, the

industry has successfully put forward its case: In contrast to banking, existing insurance regulations have largely proven effective. Given that record, any radical changes, inspired by ill-conceived systemic threats emanating from the industry, would be brinkmanship.

So far, policymakers seem to agree. But there is no time for complacency. The regulatory agenda is expected to remain in flux. The industry's leeway in asset management and product design could be further restricted, capital charges for liquidity risk increased and "living will"-type of resolution mechanisms revisited.

Such a scenario remains in the realm of the possible, particularly as many policyholders and public opinion in general still look critically at insurers' role during the crisis: By many, AIG's downfall is considered a failure of an insurance giant, rather than the consequence of a reckless expansion into non-core areas of business. Also, the industry's emphasis on what distinguishes it from the banking world is sometimes considered a rather opportunistic u-turn compared to what was preached and practised until 2007: the "convergence" between banking and insurance, both in retail and wholesale business. Larger insurers and reinsurers especially face certain credibility issues vis-à-vis the public.

Against this backdrop, SME insurers who account for a significant part of the value created and jobs offered by the industry should assume a more visible role in the current regulatory debates and capitalise their "credibility bonus" to advance the collective interests of the industry. An increased involvement is also set to be in their specific own interest: If larger players are allowed to shape the legislative and regulatory agenda, SME insurers could well draw the short straw.

The Solvency II project in the European Union is a case in point: Many smaller market participants are severely concerned about the new regulatory framework's heightened capital requirements which tend to penalise less well-diversified insurers as well as the enormous amount of internal resources required to comply with the new risk governance and reporting requirements. Some SME insurers even consider Solvency II a 'conspiracy' orchestrated by their larger competitors to enforce industry consolidation via regulatory means.

That seems to be a false suggestion though. In any case, many CEOs of SME insurers in Europe will probably conclude that, on hindsight, an earlier involvement could potentially have mitigated some of the adverse effects likely to be suffered by smaller market participants. Going forward, in light of the financial crisis, their views and opinions will certainly be more sought after – an opportunity that should not be missed. ■

The author can be contacted at [kai-uwe.schanz@schanz-alm.com](mailto:kai-uwe.schanz@schanz-alm.com)