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How to Keep the Financial Stability of Insurance on the Balance Sheet and Ways to Develop this Area

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Abstract: While the insurance sector has not been the focus of financial stability institutions until recently, a number of questions have recently arisen. Indeed, the following issues have led experts to reflect on the new role being played by the insurance sector in major economic and financial balance sheets: overreaction of insurance companies during a stock market downturn, airline shutdowns following terrorist attacks on the World Trade Market. Center, the discovery of the strategic role of reinsurance in ensuring the sustainability of risk coverage, the growing influence of financial conglomerates, the transfer of credit risk from the banking sector to other sectors such as insurance and reinsurance, and temporary or long-term doubts about certain types of coverage. Against this background, it is natural to think about the potential risks of the insurance sector for national and international financial stability.

In this article, we assess the extent to which the insurance sector can be a source of systemic risk. In addition, we will take a closer look at a number of recent developments that have affected the insurance sector and may represent new sources of financial risk, as well as the role of the state in the stability or instability of the insurance sector.

Key word: insurance sector, complexity of financial conglomerates, risk transfer, reinsurance, source of systemic risk for the economy, solvency of insurance companies, reinsurance in the sustainability of risk coverage.

Introduction

The major shocks hitting the insurance sector have raised questions about the sector's role in financial stability and whether it is a potential source of systemic risk. The complexity of financial conglomerates, risk transfer and reinsurance have reinforced these concerns. From an in-depth analysis of both its characteristics and the empirical data on possible contamination from this sector, it can be concluded that the insurance sector is not a source of systemic risk to the economy.

However, it can become a source of destabilizing shocks for both the financial sector and the economy as a whole. The emergence of financial conglomerates, the transfer of a significant share of credit risk to the insurance sector, and the special role of the reinsurance sector do not change this conclusion. Its ability to destabilize the financial system clearly justifies the regulation of this sector and, in particular, the monitoring of the solvency of insurance companies. However, the long-term and very long-term horizon of the insurance sector requires not only specific rules, but also rules that are flexible enough

to adapt to changing circumstances. Such regulation will allow the insurance sector to play its expected role as a shock absorber.

Discussion and Results

From a financial stability perspective, it is important to assess the extent to which the insurance sector, like the banking sector, represents a potential source of systemic risk and the likelihood that it will provoke a liquidity crisis. In the banking system, systemic risk refers to a default that is initially limited to a few institutions, then spreads to the entire financial sector, regardless of the solvency of the institutions concerned, and finally can lead to the collapse of payment systems or a general economic crisis[1]. The shock wave spreads through interbank lending and bank lending to companies, without which the financing of the economy and, consequently, economic activity would be interrupted. Systemic risk should not be confused with a general shock that affects all banks simultaneously and jeopardizes their solvency, such as an interest rate shock, an inflationary shock, or a stock market shock. The contagion associated with systemic risk can be largely psychological, given that agents in a world of imperfect information simply interpret the failure of the first banks as a threat to other banks, which leads to a loss of confidence in them. The scale of the contagion is unpredictable and could become self-fulfilling. While the initial default may simply be a "solvency crisis", the spread of the crisis through spread becomes a "liquidity crisis" as agents lose all confidence in the system. .

On examination, the insurance sector does not appear to be a source of systemic risk. This does not mean that it has not been subject to crises or that insurance companies are immune to macroeconomic shocks.

It also does not mean that transfers from this sector to other sectors, in particular to the banking sector, do not exist, as was observed in “extreme situations”. But insurance contagion has never reached the same proportions as bank contagion, and its transmission channels have not been clearly identified, as they tend to differ from one crisis to the next. Cases of bankruptcy of an insurance or reinsurance company that led to a macroeconomic crisis are not known. The only such case occurred in Jamaica in 1996. However, this incident was related to the fact that the insurance company in question belonged to a banking conglomerate with a monopoly in the local market, and not to the systemic risk inherent in the insurance sector. Thus, we can assume that the economy is less exposed to "systemic risk" from the insurance sector than from the banking sector. There are four main reasons for this.

The production cycle in the insurance sector is opposite to the banking sector. In the banking sector, loans create deposits: the liquidity that banks inject into the economy in the form of loans does not reflect past wealth creation, but only the expectation of future wealth creation. However, in the insurance sector, it can be said that "deposits" make "loans": the liquidity that insurance companies inject into the economic system simply transfers the liquidity generated from the wealth already created by the insured. Consequently, at the macroeconomic level, the bankruptcy of the insurer only reinforces the redistribution of capital and wealth at the expense of the insured. This redistribution was implicit but not felt before the failure, while the failure of a bank directly limits the potential for future wealth creation.

The turnover rate of liabilities in the insurance sector is lower than in the banking sector. The short-term liquidity of bank deposits is vital as they are used by agents in their day to day activities, while the liquidity of insured persons' claims against insurance companies is only necessary for a portion of these claims. In the non-life insurance sector, liquidity requirements arise from claims that are theoretically independent of the behavior of the insured. However, in the banking sector, changes in deposits are always the result of deliberate actions. In the life insurance sector, the amounts invested by customers are just as stable as the amounts invested by bank customers, but for completely different reasons: the stability of bank deposits is the result of the fact that inflows statistically tend to offset large outflows, while the stability of life insurance is simply depends on the weakness of the outflow.

[1] As W. Baghhot (1873) wrote: "Every banker knows that if he has to prove that he is trustworthy, no matter how convincing his arguments, in fact his credit will be lost."

Insurance claims are less liquid than bank deposits. Depositors can withdraw funds from banks at any time without notice, without being subject to financial penalty or taxation. However, in the case of insurance investments, the withdrawal options are more limited and cost the client more.

Withdrawal is almost impossible in the case of life insurance. Early withdrawal is possible in life insurance and has some similarities to the withdrawal of bank deposits, but the scope and possibilities are limited due to the following three deterrent mechanisms: penalties, usually applied in favor of the insurer (in France they can be as high as 5% of the contract value); loss of the tax benefits normally associated with this type of contract in Europe (in France, an exit before the end of the eight-year period results in a much higher taxation of interest than the flat rate of 7.5% applied after eight years); the period of actual reimbursement of the invested funds, which prevents the immediate withdrawal of funds (in France, the insurer has two months to pay off the redemption value of the contract).

The network of interdependencies in the insurance sector is much less dense than in the banking sector. Apart from equity relationships within groups and financial conglomerates, which we will discuss next, financial relationships between insurance companies and other financial institutions are much less dense than between banking institutions, and relate mainly to the reinsurance and asset management sectors. The insurance sector has nothing to do with the extremely dense and volatile network of interbank lending, which is a source of instability typical for lenders. If savings-related premiums are subtracted to take into account only insurance risk premiums, the share of premiums – and therefore risks – ceded by insurers to other insurers or reinsurers is no more than 13% of the total.

Consequently, during the asset downturn of the late 1980s and early 1990s, the insurance sector, unlike the banking sector, was in no hurry to sell off its assets. During the Japanese crisis of the 1990s, insurers could continue to contribute to the liquidity of the economy for a decade before being hit hard, while banks were hit hard at the start of the crisis and put pressure on the national economy for a decade. economy, despite massive support from monetary policy and fiscal stimulus. The concerns that have arisen recently are not so much about insurance itself, which, as we have seen, does not create risks of structural instability, but about links between the insurance sector, the banking sector and the reinsurance sector. In this regard, special attention is paid to financial conglomerates and credit derivatives. These concerns are discussed below.

1) *Financial conglomerates* offer a number of activities within the same group, usually banking, insurance and investment services. Most banking and insurance groups have developed their own financial services divisions to manage the large amounts of revenue they generate.

2) *Credit derivatives*

3) *Reinsurance* can be defined as the acceptance by an insurer of some or all of the risks assumed by another insurer. The insurer is solely responsible for the financial obligations under the policies issued by it; the reinsurer takes on only part or all of the cost of the risk when it materializes. In accordance with the provisions of the reinsurance contract, the distribution of risk with the reinsurer can be proportional (in 80% of contracts in the case of automatic reinsurance) or disproportionate (in 16% of contracts, the remaining 4% falls on facultative reinsurance). Non-proportional reinsurance is also known as excess loss or stop loss reinsurance. In the case of excess loss reinsurance, the reinsurer provides coverage for those claims that exceed a certain fixed amount but are still below a set ceiling. In the case of stop-loss reinsurance, which is less common these days, the reinsurer covers a share of the insurer's annual loss above an upper limit and possibly below a certain fixed amount.

Conclusion

In general, while we cannot deny that the difficulties of some insurance companies can lead to severe economic or financial shocks, the fact remains that insurance and reinsurance do not in themselves represent an actual source of systemic risk or even serious financial instability. In fact, everything indicates that they act as shock absorbers. They only seem to be a source of instability in very specific circumstances independent of the insurance itself. Therefore, we should not underestimate the risks

associated with some of the changes observed in this sector. At present, the reaction of insurance regulators is probably in line with the nature of these risks. However, it is additionally useful:

- Accelerate Asian reforms to regulate the solvency of insurers,
- scrutinize the coordination and consistency of supervision of financial conglomerates,
- collect more complete data on the transfer of credit risk,
- reduce the risks of instability associated with the existing prudential system,
- provide for a procedure for managing the insurance crisis at the macroeconomic level,
- Strengthen the legal field of insurance as much as possible.

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