

**Written Comments for the Observer Hearing  
at the IAIS Technical Committee meeting  
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**Topic 1: Insurance: Systemic risk, interconnectedness and macro-prudential tools**

Do you intend to present orally (yes/no)? Yes

**Comments** – Please summarise the specific issues you are addressing and to which questions you are responding, if any.

On behalf of the Association of Bermuda Insurers and Reinsurers (ABIR) we offer these comments on each question posed by the Technical Committee. ABIR represents property and casualty insurers and reinsurers. From a regulatory context these questions can be addressed for three insurance sectors: property and casualty insurance; property casualty reinsurance and life insurance/reinsurance. ABIR's remarks focus on the two property and casualty sectors. The questions allow us an opportunity to provide thoughts and commentary on a wide range of "big picture" regulatory issues. We appreciate the opportunity to make these comments. Our comments today may or may not differ from comments we would file on specific regulatory policy papers that will be submitted or are already before policy making committees. These comments reflect ABIR's views, but individual members of the Association may hold different views.

1. In your view, what is systemic risk or risk of interconnectedness for the insurance sector?

*First we need a definition of systemic risk and we distinguish that from interconnectedness. A working definition of systemic risk would be: a risk factor inherent in a business sector which when taken to an extreme can cause damage to the overall economy. Underwriting risk drives the enterprise risk of the property and casualty insurance and reinsurance sectors. These sectors have demonstrated tremendous financial strength after being tested in recent years by underwriting losses including the 9/11 terrorist attacks (and the ensuing stock market losses), the historically worst ever US hurricane seasons of 2004 and 2005 and the 2008 global economic crisis from which jurisdictions are currently emerging. Notably, large paradigm shifting shock losses that occur in this business are uncorrelated to general economic risk. In each case, these sectors were able to maintain service to customers, pay claims and continue to conduct business on a going forward basis. (We deal with "interconnectedness" risk issues in Question 3.) These sectors have been able to raise capital quickly following such catastrophic events. Generally these sectors are characterized as having a multitude of players affording clients with many choices of an insurance or reinsurance provider. To some degree concentrations of business are high in certain classes of business, but competitors are free to enter and exit markets so that new competitors can emerge given market opportunities. These sectors are generally characterized by an absence of barriers to entry. These companies tend to be capitalized in amounts well in excess of regulatory requirements with the needs of customers and rating agencies, particularly for the wholesale market, setting the capital requirements as a key condition of competitive standing. As a result of these factors we don't see property and casualty insurers or reinsurers as posing a systemic risk to the global financial system. We concur with the conclusions of the Group of 30 which found in a 2006 report that the reinsurance sector is unlikely to be a source of systemic risk. We refer to the letter filed by Global Reinsurance Forum for statistical detail on this report. To the degree that the IAIS has concerns about the systemic risk posed by reinsurers we would recommend that the work be referred to the IAIS Reinsurance Transparency Group. The RTG assisted the IAIS with the previous request from the Financial Stability Forum (now the FSB) for research*

about the reinsurance business and the transparency of risk which it retained. With regard to insurance companies generally, we note that Scott Harrington, Ph.D., Wharton School, University of Pennsylvania, has found that “systemic risk is low in insurance markets compared with banking, especially for property/casualty insurance, in part because insurers hold greater amounts of capital in relation to their liabilities, reducing their vulnerability to shocks.” In addition, Harrington found that tagging insurers as “systemically significant” would likely reduce “market discipline” and aggravate “moral hazard.” Guaranty funds operating in wholesale commercial business markets pose a similar moral hazard. Moreover, Harrington has found, as have other analysts, that the AIG problem resulted from its “banking” risk transactions, not its insurance operations. No doubt AIG has now demonstrated it posed systemic risk to the overall economy, but that was because of its “infection” with out of control banking risk. ABIR does not represent financial conglomerates and thus we defer commentary on the systemic risk they pose to others with more direct experience. Pegging systemic risk to companies that do not pose such inherent risk can be counterproductive. Harrington (and the Geneva Association) has noted that if insurance companies are deemed to be systemically important that this can create market distortions which will work to the detriment of the broader insurance and reinsurance markets. Some have pointed to capacity shortfalls in property and casualty insurance and reinsurance markets as posing a systemic risk to the general economy. To the degree that jurisdictions have experienced problems in the past with regard to an inadequate supply of property and casualty insurance, we note that governments have created temporary facilities (usually with insurance industry funding, but sometimes with taxpayer support) to ensure that consumer insurance can be placed. Typically the experience with these funds is that they contract as the market reaches an equilibrium point and private sector supply grows to meet current demand. At times the need for such facilities can be traced to counterproductive legislative or regulatory actions that constrained the flow of capital into the sector. Since these market issues have been dealt with in existing public policy and regulatory frameworks (of various jurisdictions) we don’t believe they justify pegging a new level of systemically related regulation to property casualty insurance and reinsurance markets.

2. What are the differences between systemic risk in the insurance sector and in the banking sector?

Property and casualty insurers and reinsurers are in a fundamentally different business than banks. We cannot foresee anything like the proverbial “run on the bank” that infects the banking sector with a different risk profile from property and casualty insurers and reinsurers. Equally important with regard to the recent financial crisis, in contrast to insurers, banks exhibited very high leverage and a tendency to distance themselves from risk bearing and to focus instead on fee generation. Insurers have learned from a series of actual experiences the need to closely manage and measure risk and to retain enough risk to understand the true loss potential associated with the business written. Examples of experiences that have tested the financial strength and risk management practices of insurers are: the Lloyd’s spiral of the 1980’s, the US’s Unicover workers compensation spiral of the 1990’s, the evolution of asbestos and environmental liabilities in the US in the 1980’s, the terrorism risk threat that exploded after the 9/11 US terrorism attacks, and the 2004/ 2005 US hurricane seasons which exhibited paradigm shifting frequencies and severities for US hurricanes. The capital strength of property and casualty insurers and reinsurers and the need to maintain capital to match with retained risk distinguish these insurers from banks. Standard and Poor’s is now rating property and casualty reinsurers on their enterprise risk management (ERM). It is worth noting that three ABIR members rank in the top four as measured by S & P. Regulatory accounting requirements for the insurance and banking sectors have been fundamentally different. Insurers were required to prefund for long tail liability exposures, while banks were not. Property and casualty insurers’ assets were required to be liquid. These insurance sectors have sacrificed higher ROE’s in order to maintain strong balance sheets. These insurance sectors do not conduct business with the leverage associated with banks. These insurance sectors do not conduct

*business, as key banks did, with the goal of transferring substantially all risk to third parties. The experience from the aforementioned insurance loss events demonstrated that insurers in these sectors were able to honour their obligations for claims events; and to raise capital to return to financial health if necessary to trade going forward; while new carriers were also able to enter markets to take advantage of market opportunities created as a result of companies in trouble. In fact the Bermuda wholesale insurance and reinsurance markets benefited from the financial crisis experienced at Lloyds in the last part of the 20<sup>th</sup> Century. Similarly, the US property/casualty reinsurance business benefited from the Unicover workers compensation spiral that adversely affected the life reinsurance market. The successful conclusion of the Equitas runoff of the old Lloyds' business demonstrates that property and casualty insurance and reinsurance sectors have a fundamentally different settlement and resolution pattern than do other non-insurance financial sectors. Let's look at this issue from the ceding insurers' perspective as well. Ceding insurers protect themselves against the risk of loss from reinsurance counterparties by diversifying their reinsurance partners. Although there are a handful of very large reinsurers, there is sufficient competition in the reinsurance markets to afford ceding carriers many choices and thus allow them to protect against a concentration of recoverables from only a handful of counterparties. Regulatory oversight also is focused on whether cedents have a concentration of risk in reinsurance counterparties. The Bermuda market plays a key role in affording this diversification opportunity to global ceding insurers. Bermuda's market is not dominated by a single reinsurance company of enormous scale. Rather what Bermuda brings to the market table is a basket of small and medium sized property and casualty insurers and reinsurers that collectively provide a significant amount of reinsurance and large scale insurance capacity. We also note that the capital supporting Bermuda's property and casualty insurers and reinsurers is from a global universe – Canada, Europe, Japan, the United States—and thus itself demonstrates a strong foundation via diversification. The capital itself is from individual investors, hedge funds, mutual funds, pension managers, and insurance groups. Finally, property and casualty insurers and reinsurers (in their insurance risk bearing businesses) do not face the potential for the calamitous customer driven exodus that can force nearly immediate catastrophic liquidity problems. Regulatory attention is properly focused on the need for insurers to maintain liquid invested assets so that catastrophic claims can be paid. The norm in the property and casualty insurance business is to be able to dispense of troubled business portfolios or to manage troubled companies by an orderly runoff of business as the policies expire and the liabilities mature. The US asbestos and environmental crisis of the 1980's was an example of a "creeping death" scenario for major commercial property casualty insurers and reinsurers that was successfully averted by the long payout pattern -- the distribution of losses over time. Notably, the 9/11 aftermath also illustrated that this normal troubled company runoff pattern succeeded even with the combination of a large "shock loss" coupled with a substantial decline in the value of invested assets. History shows many exits from the US and European property and casualty insurance and reinsurance markets. These exits have been handled in an orderly basis under an existing legal framework.*

**3. Does the interconnectedness between (re)insurers lead to systemic risk? Are there systemic risk issues with the interconnectedness between (re) insurers and banks and/or the credit markets?**

*The linkage of the wholesale insurance market to the financial markets is characterized best by access to capital and liquidity of assets held to pay claims. The inability to access capital can prevent new insurers and reinsurers from entering markets and can prevent existing insurers from raising the capital to continue in business to assume future insurance and reinsurance liabilities given adverse loss experience. The inability to sell assets (due to illiquid markets) can also imperil property and casualty insurers and reinsurers as they need to pay customer claims. The "freeze up" of the capital markets led to a substantial drop in the amount of catastrophe securitizations that have been completed in 2009. A long term constrained capital market would fundamentally limit the ability of insurers to function in meeting customer needs. The experience with the current financial crisis is that*

*the financial assistance from governments to restore capital markets has allowed for insurers and reinsurers to access the needed capital. This experience demonstrates that government assistance to the banking/capital markets is critical in supporting all business sectors, including insurance and reinsurance. Policymaker attention should be focused on the capital markets. Deep, liquid, reliable capital markets provide a solid foundation on which insurers and reinsurers can stand. The interconnectedness risk between property casualty insurance and reinsurance sectors is already subject to prudent regulatory oversight and does not pose systemic risk to the economy. (See more on this in our response to Question 2 above.) Finally, we offer a caution, imposition of guaranty funds on the property casualty commercial insurance and reinsurance markets would create a new kind of “interconnectedness” risk where healthy companies face heightened risk of loss because of the financial problems of their competitors; including the moral hazard Harrington has noted.*

4. What role should the IAIS play in addressing systemic and interconnectedness risk? *The IAIS should play a leadership role in explaining to financial markets’ regulators and senior government officials the distinguishing characteristics that differentiate insurance from other financial markets. The historical track record of the property and casualty insurance sectors (as illustrated in the answers to Question 1 and 2) provides evidence of how these sectors have been able to pay their obligations in the event of catastrophic “shock losses” without the need for governmental intervention. The intervention of various governments following the 9/11 attacks to provide terrorism insurance facilities to support going forward business relationships similarly demonstrates that insurance capacity needs can be met by existing regulatory and public policy frameworks. The IAIS’ Reinsurance Transparency Group (RTG) has previously conducted reinsurance on the risk bearing role of reinsurance markets and we would suggest again that it is a useful resource for the IAIS to tap into. Via the RTG the IAIS can access the expertise of the leading reinsurance market regulators and the leading reinsurers.*
5. How could insurance supervisors apply macro-prudential tools? *Insurance supervisors in the US and European markets, most affected by the financial crisis, and the Bermuda insurance supervisor, have done an excellent job with their current tools in sorting through the problems presented by insurers that were overly exposed with banking risk. Their actions speak for themselves in the orderly insurance and reinsurance markets that we are witness to today. Regulators already have macro-prudential tools at their disposal. We believe capital requirements are the fundamental macro prudential tool for regulators. Capital requirements are risk based and thus increase as assumed insurance risk increases. This seems to be a natural, logical and well tested macro prudential tool in many markets. The Bermuda risk based capital regime is characterized by several “best practice” tests that may be of value to other jurisdictions. Our risk based capital framework is built upon a 99% tail VAR measurement. In addition, the mandatory stress and scenario tests, as used in Bermuda, are also a useful tool in testing the resilience of companies and measuring capital adequacy. These tools were used by the BMA during 2008 and 2009 to measure the performance of Bermuda’s property and casualty insurers and reinsurers against unprecedented capital loss scenarios presented by the financial crisis and theoretical and real natural disasters. There is also a risk of regulatory over-reaction. New, prudent risk based capital standards for insurers need to be tested in the market. A wholesale application of new capital requirements without appropriate field testing can have counterproductive results.*
6. What macro-prudential tools do you believe would be most effective for addressing systemic risk in the insurance sector? *See response to question 5 above.*

## Topic 2: Effective supervision – lessons learned from the financial crisis

Do you intend to present orally (yes/no)? Yes

**Comments** – Please summarise the specific issues you are addressing and to which questions you are responding, if any.

1. In your view, how could the legal framework and structure of regulation of insurance companies and groups in particular be improved (e.g. capital, risk management, governance and financial reporting requirements, etc.)?

*Jurisdictions which have not implemented a risk based capital framework should do so. Fixed capital requirements for major global property and casualty insurers and reinsurers are inadequate. Mandatory stress and scenario testing give both regulators and the regulated insight into how the company's financial performance can be tested by specific events. In Bermuda, the BMA also provides regulated insurers with peer group comparisons – or benchmarking data—with regard to these stress and scenario tests. Public financial statements should be available for legal entities. Property and casualty insurers and reinsurers should be subject to regular financial examination by their regulators. Group supervision requirements should be developed and implemented where they don't exist. Regulatory cooperation amongst various jurisdictions is essential to ensure there is effective supervision of global insurance groups. The IAIS's developing solvency regulation framework holds promise as an international benchmark against which various jurisdictions regulatory structures can be measured. Europe's developing Solvency II transparency requirements will help guide other jurisdictions including Bermuda in the development of additional disclosure requirements.*

2. What improvements can be made to supervisory methods and processes (e.g. methods of intervention, expertise of supervisory resources, frequency of on-site and off-site examinations, etc.)?

*We see the essential ingredient of effective regulation as being the employment of talented, trained, experienced and dedicated staff. We envision a “three legged stool” test of the key qualifications for regulatory staff managers: a. Academic and technical education; b. Career experience in the business sector being regulated; and c. Demonstrated competency in the implementation of regulatory practice overseeing insurers. Career industry experience in the field being supervised is underemphasized in the hiring of regulatory management staff today. The key risk to property and casualty insurers and reinsurers is underwriting decision making. Actual knowledge of the underwriting process and the analysis of insurance risk are essential for managers in regulatory agencies. Academic training is an imperfect substitute for such experience. Academic training, however, in the key disciplines such as statistical analysis, finance, accounting, actuarial science and other specific areas of business management provide a firm foundation upon which regulatory talent can be developed. Much as the IAIS has built its staff with diverse jurisdictional expertise, individual regulatory agencies could do the same. We think regulators would benefit from internationally diverse staffs just as global company managements have benefited from such diversity. Finally, we believe the solvency regulators benefit most from interacting with their peers in other jurisdictions. Interaction with peers leads to a natural process of better understanding alternative approaches to regulation. Regulatory colleges can be another effective way to efficiently provide knowledge transfer amongst regulatory employees. In person regulatory colleges can be supplemented with regular conference calls as appropriate for the supervision of global property and casualty insurance and reinsurance groups. Ultimately, as we fully implement group supervision we would expect that insurance regulators may locate principals in key markets (outside of the domestic jurisdiction) for the global insurance groups which they regulate. Internationally diverse global insurance groups logically will lead to internationally diverse global insurance regulators.*

3. What are the lessons learned about the supervision of insurance groups? What should be

done differently?

*The key lesson learned is that we are only at the beginning stage of development of a workable group supervision framework. The political will for effective group supervision, which will include deference to a lead regulator, is being tested. Designation of a lead supervisor and deference to that supervisor should be a core principal of any group supervision framework. Effective group supervision also means the elimination of redundant, contradictory and inefficient jurisdictional regulation. Global insurance groups will be impeded by imposition of a group framework that does not provide for efficient, clear and timely regulatory decision making. Although reporting and regulatory approval for material transactions with holding companies are important supervisory powers, the AIG experience demonstrates that there needs to be actual regulatory supervision of activities conducted within holding companies or in non insurance operations of global insurance groups. Financial reporting or disclosures are insufficient. There may also have to be regulatory requirements governing the risk outside the insurance sector that may cascade through the insurance group.*

4. What are your views on the IAIS proceeding with research into the design and practicality of a common assessment framework for insurance group supervision? What elements (E.g. quantitative, qualitative, structure, etc) should be considered in a common assessment framework for insurance groups?

*Developing a common assessment framework will be extremely difficult. Having said that, development of such a framework seems to be a logical extension of the existing IAIS work with regard to solvency regulation standards. We believe national and supra national solvency regulation proposals ought to be tested in the real world. The experience in Australia, Japan, Bermuda, the United States, Canada, and Switzerland as examples will inform the ongoing global standard setting. The build out of Europe's Solvency II and its eventual implementation of a comprehensive risk based framework will provide important opportunities to learn about functionality, efficiency and practicality of new regulatory considerations. Over time, experimentation and knowledge from these systems can lead to development of a new common assessment framework. Such a framework ultimately will be most beneficial if it provides for a core measurement of the insurer's financial strength that can be relied upon by both regulators and customers. In the meantime, it seems that perfecting existing regulatory models should take priority. Design work on a common assessment framework can be valuable and could provide a benchmark against which regulatory solvency tests could be compared. Work can proceed, but it needs to be carefully done and not done in such a way as to bias the outcomes of the current regulatory framework tests now in place or under development. We live in functioning democracies and we understand there will be the practical constraints associated with jurisdictional politics.*