Swiss Re

New Swiss Re sigma study shows: reinsurance poses no systemic risk

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Zurich, 4 September 2003 – Reinsurers play a key role in absorbing major risks in the insurance sector. Are they themselves a risk to the insurance system, the financial system and the economy as a whole? No, says sigma based on empirical evidence and an analysis of possible transmission channels of adverse shocks.

For some time, a discussion has been under way with regard to the systemic risk inherent in reinsurance. It questions the reinsurer's role during capacity shortages and the effects this has on the primary insurance sector, examines the impact of reinsurer bankruptcies on primary insurers and whether reinsurers could disrupt the financial markets in their role as investors or insurers of credit risks.

What does "systemic risk" mean anyway? The bank run is the most classic example of systemic risk: bank customers lose their confidence in a bank and withdraw all of their money. This triggers a chain reaction which drives other banks into bankruptcy. The financial system in turn collapses, which has severe consequences for the economy. The question is whether similar contagion effects can arise from reinsurance obligations or other financial relationships. For a risk to be classed as systemic, the risk of contagion must have grave consequences for at least parts of the economy.

Swiss Re's *sigma* study contributes to this debate by analysing past disruptions to the economy where reinsurers were involved and identifying the channels via which contagion was transmitted to the real economy. It then estimates the impact on the insurance and financial sectors. The most important results of this study can be summarised as follows:

- Supply shortages in the reinsurance sector have, in the past, led to temporary reductions in available capacity. However, the reinsurance sector was not to blame for really serious disruptions, such as the liability crisis in the US or the absence of insurance cover for airlines after 11 September 2001.

- The primary insurance sector on the whole or individual national markets are highly unlikely to come under threat, as primary insurers tend to distribute their cessions widely. Furthermore, the risk of reinsurance bankruptcies is extremely slight. Bankruptcies, measured in terms of ceded premiums to non-affiliated companies, totalled only 0.02% in the period 1980-2002. This low risk of default is confirmed by the credit ratings: even after recent downgrades most of the biggest reinsurers are rated AA or better by S&P.

In view of the particular susceptibility of the banking sector to systemic risk, major contagion effects are most likely to arise from the relationship between reinsurers and banks. Links to the banking sector tend to be in the form of direct shareholdings or the reinsurers' assumption of banks' credit risks. The ban enforced by the supervisory authorities on the multiple use of equity capital within a financial conglomerate has reduced the risk of contagion among shareholdings considerably. As to credit derivatives, reinsurers have traditionally managed only strongly diversified credit risk portfolios in the senior or super-senior tranches of the market.

This *sigma* study does not exclude the possibility of primary insurers being affected considerably by a reinsurer's bankruptcy or, in very rare cases, being themselves made insolvent. The study also notes that inappropriate reinsurance cover can have a similarly harmful effect on a primary insurer, although obtaining sufficient cover is the insurer's own responsibility. Overall, however, the study concludes that there is almost no evidence of systemic risk in the reinsurance sector. What this means is that, even in the case of extreme events, it is highly unlikely that the insurance system will find itself unable to carry out its function due to a capacity shortage or following bankruptcies in the reinsurance sector.

Notes for editors:

Swiss Re is one of the world's leading reinsurers and the world's largest life and health reinsurer. The company operates through more than 70 offices in over 30 countries. Swiss Re has been in the reinsurance business since its foundation in Zurich, Switzerland, in 1863. Through its three business groups Property & Casualty, Life & Health and Financial Services, Swiss Re offers a wide variety of products to manage capital and risk.
Traditional reinsurance products, including a broad range of property and casualty as well as life and health covers and related services, are complemented by insurance-based corporate finance solutions and supplementary services for comprehensive risk management. Swiss Re is rated "AA" by Standard & Poor's, "Aa1" by Moody's and "A++" by AM Best.

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The English, German, French, Spanish, Italian, Japanese and Chinese versions of this *sigma* study are available electronically on Swiss Re's website: http://www.swissre.com/sigma .

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Data from selected figures and tables are available from the *sigma* chartroom on the Swiss Re Portal: http://www.swissre.com/portal.