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Curbing systemic risk in the insurance sector: A mission impossible?

Paola Bongini [a], Laura Nieri [b, *], Matteo Pelagatti [a], Andrea Piccini [c]

[a] School of Economics and Statistics, Università di Milano-Bicocca, Via Bicocca degli Arcimboldi, 8, 20126, Milan, Italy
[b] Department of Economics, Università di Genova, v. Vivaldi 5, 16126, Genova, Italy
[c] State Street Bank Luxembourg S.C.A., 49 Avenue J.F. Kennedy, L-1855, Luxembourg

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ABSTRACT

This paper addresses the issue of systemic risk in insurance and investigates how financial markets evaluate the introduction of a new regulation addressed to global systemically important insurers (G-SIIs). We analysed the stock price reactions and the evolution of the distance-to-default of a sample of 44 of the world's largest insurers to the publication of the first list of 9 G-SIIs and the release of information regarding their new capital requirements and other policy measures. The results of our event study suggest that, overall, investors doubt the effectiveness of the new regulatory framework in reducing systemic risk in the insurance sector and curbing the moral hazard implications of a "too systemic to fail" policy.

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1. Introduction

The international financial crisis that began in 2007 uncovered the importance of systemic risk in the financial sector, and the occurrence of episodes such as the Lehman Brothers failure or the American International Group (AIG) federal bailout emphasised the necessity to develop a specific regulatory and supervisory system to address this issue. As a matter of fact, in 2008 the Financial Stability Board (FSB) received the mandate from the G20 leaders to envisage new measures to avoid the distress of a systemically important financial institution (SIFI) potentially spreading to the remainder of the financial system and causing serious damage to the real economy. In addition, the mandate sought to curb the moral hazard implications associated with the expectation of public intervention in favour of these institutions. Since then, national and international regulatory authorities have been prompted to: (i) identify financial institutions that are to be considered systemically important and (ii) take measures to mitigate the impact of the distress/failure of such institutions and discourage the development of systemic risk, thus reducing the probability of a public sector intervention or bailout .

* Corresponding author..
E-mail addresses: paola.bongini@unimib.it (P. Bongini), laura.nieri@unige.it (L. Nieri), matteo.pelagatti@unimib.it (M. Pelagatti), a.piccini@statestreet.com (A. Piccini).

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In November 2010, the Financial Stability Board announced that new regulatory measures designed for systemically important financial institutions (SIFIs), similar to those devised for the banking sector,[1] would also be applied to the insurance industry. Accordingly, in May 2012, the International Association of Insurers Supervisors (IAIS) proposed a new regulatory framework concerning Global Systemically Important Insurers (G-SIIs) and, on July 2013, the FSB released the first list of G-SIIs,[2] and the IAIS specified the related policy measures, whose implementation time frame spans from 2014 until 2019.

The introduction of the specific regulation concerning G-SIIs has launched a wide debate among scholars, policy makers and the insurance industry. In fact, in contrast to the banking sector, the importance of systemic risk in the insurance sector is not univocally recognized. According to the IAIS, traditional insurance activities are not a concern from a systemic risk perspective; during the international financial crisis, AIG alone was hit by systemic risk, whereas the other insurance companies proved to be resilient to the general turmoil. However, insurers can also engage in banking-like activities that, indeed, can be a source of systemic risk and can increase the interconnectedness between the banking and the insurance sectors. This evidence could also justify the introduction in the insurance sector of a "too systemic too fail" regulation whose ultimate goal is: i) to urge insurers to become less systemically important, and provide non-GSIIs strong disincentives from becoming G-SIIs; ii) to reduce the probability of failure of G-SIIs and the expected systemic impacts that such a failure may determine and iii) to limit the potential for regulatory arbitrage between different sectors of the financial system. Consequently, systemic insurers must bear the burden of heavier regulation and comply with higher capital requirements in exchange for the implicit protection provided by a "too systemic to fail" regulation.[3] In this perspective, the new regulatory measures are introduced to adjust market failures. Given the spill-over effects associated with the failure of a systemic insurer and the ensuing expectations of a public bailout, systemic insurers have an incentive to engage in risky activities that will ultimately increase their return without exposing them to a real risk of failure. Regulation attempts to offset these moral-hazard incentives and to avoid G-SIIs' enjoyment of an implicit free public guaranty.

To fully understand the potential impact and effectiveness of the new regulation on systemic risk, one must also recall that, by the time the FSB urged the introduction of the G-SII regulation, other regulatory initiatives relevant for addressing systemic risk had already been announced or finalised by the IAIS.[4] In addition, the overall regulatory regime of the insurance sector is not homogeneous across countries at the national level,[5] and this may affect the results that can be achieved by the introduction of a supra-national regulation as that on the G-SIIs. Whether the new G-SII regulation is truly able to curb systemic risk and the related moral-hazard incentives, thus increasing the effectiveness of the extant regulatory framework, remains an unsettled issue. In this paper, we assess the markets' evaluation of the regulators' initiative to reduce the systemic relevance of a named group of G-SIIs and the subsequent expected public intervention in case of their distress. We examine the equity market reactions following major regulatory steps by the FSB and IAIS that ultimately led to the disclosure of the first G-SII list and the new regulatory measures. Additionally, we test whether these reactions were consistent with the hypothesis that the introduction of the G-SII rules diminishes systemic risk in the insurance sector with a benefit for the public at large or, alternatively, if they are solely deemed to be a free guaranty offered to the G-SIIs. More specifically we attempt to assess i) whether financial markets deem the new regulatory measures concerning G-SIIs as truly effective in reducing systemic risk in insurance and limiting the moral hazard associated with a "too big/systemic to fail" policy, and ii) if there are specific insurers that benefited (or suffered) more than the others from being (or not being) designated G-SIIs.

In particular, using an event study methodology applied to a sample of 44 of the world's largest insurers, we test whether the stock prices of G-SIIs reacted significantly and differently from those of other large insurers, after the methodology to identify G-SIIs was proposed (May 31, 2012) and after the disclosure of the first list of nine G-SIIs (July 18, 2013).[6] The empirical expectation is that, if markets perceived the new regulatory regime as effective in curbing systemic risk and, at the same time, correcting market failures, negative abnormal returns would accrue to the group of insurance companies named in the list of G-SIIs.

Our research contributes to the on-going debate on systemic risk in the financial sector. Our main contribution is to add new insight to the study of systemic risk in insurance, thus filling the gap in the empirical literature that analyses the effects of the G-SIFI regulation. In fact, this issue has motivated a number of studies since 2012; however, they are mainly focused on the banking sector. To the best of our knowledge, there is one study (Dewenter & Riddick, 2016) that documents the effects of a

[1] The new regulatory measures concerning SIFIs were first devised in the banking sector and eventually in 2011 the Financial Stability Board (FSB), jointly with the Bank Committee on Banking Supervision (BCBS), disclosed a first list of Global Systemically Important Banks (G-SIBs) and specified the regulatory measures they must comply beginning from 2016.

[2] In November 2014 the FSB in consultation with the IAIS released the second list of G-SIIs that confirmed the same companies designated in 2013. In November 2015, the updated list comprised a total of nine insurers with one new insurer being added and with Generali being removed.

[3] Although for insurance companies there is not a central institution that has the power to rescue distressed companies, such as the European Central Bank or the Federal Reserve Bank in the banking sector, we can expect that due to the negative externalities caused by the failure of a large and systemic insurance company, there is a high probability of a public intervention/bailout. As a matter of fact, AIG was bailed out by the US government, jointly by the Federal Reserve Bank and the Treasury, although in the US, there is not a federal protection scheme/entity for distresses insurance companies.

[4] Refer to the Insurance Core Principles n. 23, adopted by the IAIS on 1 October 2011, that addresses the issue of group-wide supervision, and the common framework (ComFrame) proposed in 2010 for the supervision of internationally active insurance groups.

[5] In contrast to the banking sector where the Basle capital standards allow for a world-wide homogeneous approach, in the insurance sector there remain significant differences across countries (for instance, Solvency II will apply solely to European insurers).

[6] We did not test the reaction to the disclosure of the second G-SIIs list because it was identical to the first list, thus it did not convey new information to the market.

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