Insurance: can systemic risk get any more systemic post Covid – 19?

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One of the central roles of the insurance sector is to contribute to financial stability by enabling natural and legal persons to take risks which they otherwise may not be able or willing to take. Insuring against business interruption is an example of insurance cover offered by global, regional and national insurance providers as well as Lloyd's of London which is the oldest and, in many ways, most agile insurance market in the world. Founded in c. 1686, Lloyd's of London has weathered a range of significant losses arising from a wide variety of triggers including the sinking of the Titanic, earthquakes and terrorist attacks (for example: the terrorist attack in New York on 11 September 2001). Yet, never, in its 334 years, before 2020, has Lloyd's of London been faced with so many business interruption claims on a global scale simultaneously.

The societal and economic impact of Covid-19 is testing the capacity of Lloyd's of London and the global insurance sector in a way it has never been tested before. Will this lead to higher capital requirements for insurers, much higher premiums, the widening of risks excluded from insurance cover, tighter limits on insurance cover or perhaps an increasing reluctance to underwrite certain risks?

The global regulatory efforts in respect of systemic risk in financial services are coordinated through the Financial Stability Board ("FSB"), an international organisation which, post the 2008 financial crisis, under the auspices of the Group of Twenty ("G20"), is responsible for monitoring systemic risks to the global economy and making non-legally binding recommendations about the global financial system.

The FSB was established in the aftermath of the 2008 financial crisis to: (i) coordinate, at the international level, the work of national financial regulatory authorities; (ii) develop and promote the implementation of effective regulatory, supervisory and other financial sector policies under the auspices of the G20; and (iii) on the recommendation of standard setting bodies such as the International Association of Insurance Supervisors ("IAIS") in respect of insurers, and the Basel Committee of Banking Supervision ("BCBS") in respect of banks designate global systemically important insurers and global systemically important banks respectively. The FSB has 68 member institutions, comprising ministries of finance, central banks, and supervisory and regulatory authorities from 25 jurisdictions as well as several international organizations and standard setting bodies, including the World Bank, the International Monetary Fund, the Organisation for Economic Cooperation and Development, the Bank for International Settlements, the European Commission and the European Central Bank and six regional consultative groups which reach out to 65 other jurisdictions around the world.

Mark Carney, the former Governor of the Bank of England and former chairman of the FSB, speaking at the FSB's meeting in Tokyo on March 31, 2016 aptly described the FSB as "not a treaty-based organisation". The FSB's decisions do not have force in international law. The

FSB is a member driven organisation which forms judgments of risks to financial stability. Where possible, it agrees international standards or approaches to policy. The relevant national authorities ultimately decide whether and how to implement such standards in their jurisdictions consistent with their national legal powers and approaches. The FSB is a process more than an institution. While this is an accurate description of the FSB's legal status, it is important to appreciate the practical significance of the political comity which generally exists among the FSB's members. Considerations of comity among the members of the FSB contribute to: (i) the evolution of views and approaches to financial regulation among national supervisors; and (ii) the likelihood that national supervisors will act according to the recommendations of the FSB. Itis likely that such political comity will make the work of the FSB increasingly relevant to the identification and effective mitigation of systemic risks to the global economy

Unlike in the United Kingdom, insurance in the U.S. is regulated on a State rather than a federal level. The National Association of Insurance Commissioners ("NAIC"), established in1871, provides a forum for individual State insurance regulators to coordinate their activities. In the U.S., the Financial Stability Oversight Council's ("FSOC's") mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 ("Dodd-Frank") includes: (i) the identification of systemic risks; (ii) promoting market discipline; and (iii) responding to emerging threats to the financial stability of the U.S. FSOC's members include federal financial regulators, state regulators, and an independent insurance expert appointed by the President. FSOC's statutory duties include: (i) monitoring the financial services marketplace to identify potential threats to U.S. financial stability; (ii) recommending to FSOC member agencies general supervisory priorities and principles; (iii) recommending to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among financial companies and markets; and (iv) designating nonbank financial companies for supervision and regulation by the Federal Reserve, including the application of prudential standards.

There are fundamental differences in the business models and balance sheets of banks and insurers. The IMF has acknowledged that the threats to the global economy posed by insurers are less significant than those posed by banks. For example, the long-term nature of some insurance liabilities and the consequent risks to the wider economy posed by such liabilities are different from the much shorter-term liabilities of banking institutions and the greater risks such liabilities pose to the wider economy. It appears to be generally accepted by the global financial services industry that the 2008 financial crisis was mainly caused by systemic risks in the banking sector rather than traditional insurance activities carried out by insurers in the insurance sector.

In July 2013, FSOC designated American International Group, Inc. ("AIG") and GE Capital Global Holdings, LLC ("GE Capital") as the first nonbank systemically important financial institution ("SIFIs"). Prudential Financial, Inc. ("Prudential") was designated in September 2013 and MetLife, Inc. ("MetLife") in December 2014. All three U.S. non-bank SIFIs have since been de-designated.

In April 2017, President Trump directed the Secretary of the Treasury, who chairs FSOC, to review the nonbank SIFI designation process and make recommendations for regulatory or legislative changes to the process. The U.S. Treasury's report, issued in November 2017, concluded that FSOC should focus more on identifying systemically risky activities than on designating individual firms, consult with regulators of companies engaging in such activities to address systemic risk, and designate individual companies only as a last resort.

The activities-based approach to the identification and mitigation of systemic risk is intended to enable FSOC to identify and address potential risks and emerging threats on a system-wide basis and "reduce the potential for competitive market distortions" that could arise from designating specific entities.

Products, activities, or practices to be reviewed include those related to: (i) the extension of credit; (ii) the use of leverage or short-term funding; (iii) the provision of guarantees of financial performance; and (iv) other key functions critical to support the operation of financial markets. Examples of markets FSOC would monitor include: (i) corporate and sovereign debt and loan markets; (ii) equity markets; (iii) markets for other financial products, including structured products and derivatives; (iv) short-term funding markets; (v) payment, clearing, and settlement functions; (vi) new or evolving financial products, activities, and practices; and (vii) developments affecting the resiliency of financial market participants. If FSOC identified a product, activity, or practice that could pose a potential "risk to U.S. financial stability"—defined as "a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy", FSOC would consult with relevant financial regulatory agencies to determine whether the potential risk merited further review or action.

The somewhat ambitious aim of the post-2008 global regulatory effort was to try to create a global regulatory level playing field for the "too big to fail" and other global financial institutions. Will one of the objectives of the post-Covid-19 regulatory effort be to attempt to reverse some of the consequences of globalisation?

When it comes to a real systemic crisis, such as Covid-19, the nation state is still the ultimate arbiter and protector of the fate of its citizens and others within its territory. In the context of global financial groups operating across multiple jurisdictions, the development of a harmonised, legally enforceable framework for the identification and mitigation of systemic risk would appear to be an Herculean task. While there continues to be increasing discussion among supervisory authorities and broad political consensus in respect of the shape of the principles generally regarded as conducive to global financial stability, the legal implementation and enforcement of such principles remains the responsibility of the competent national authorities. But for how long?

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