The Impact of Financial Crisis on Insurance Sector and the Regulatory Response

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ABSTRACT

This paper aims to discuss what happen during the 2008 financial crisis and the reason behind it. This paper also aims to analyze the impact of the financial crisis to insurance sector and how they react. This paper also discussed the Solvency II (applied by the European Commission) as well as the Malaysian Risk-Based Capital. Lastly, this paper also provides some observation and suggestion on how similar crisis can be avoided in the future as well as ways to improve the regulations.

Keywords: risk management, insurance, Solvency II, Risk-Based capital

INTRODUCTION

In the early 2008, the stress in the insurance industry first came to light. It began with the discovery of huge size of subprime loans for housing in the United States. Bank has been lending money which they did not have to house buyers who could not pay. To ensure the loans remain good, they bundle them and insured the risk with big insurance companies such as AIG, and secondary mortgage companies. When huge number of house buyers could not pay, the system collapsed. Pressures increased with the downfall of Bear Stearns and intensified with the bankruptcy of Lehman Brothers and the bailout of AIG which then triggered the global financial crisis. During this time, many financial institution and insurance companies faced with several challenges. Following the financial crisis, all organizations are taking greater interest in risk and risk management. Therefore, insurance companies responded by raising capital, increasing cash allocation and better improve the regulation.

This paper carefully examines the nature of insurance sector, what happen during the financial crisis and why, as well as its impact to insurance sector. This paper also provides some observations and suggestion how similar crises can be avoided in the future.

The nature of insurance business

Insurance companies have played very active and important role in the financial market as well as the economy as a whole. The main nature of an insurance company's business activity is by selling insurance products. This is where insured[1] will transfer their risk to insurance company[2] and insurer will promise to pay compensation to the insured in the event of any insurable event[3] that might occur during the length of the insurance contract. In return, insured will promised to pay a constant stream of premiums to the insurance companies. It is for this reason that insurer need to carefully evaluate and underwrite the risk at stake while charging appropriate insurance premiums and calculate the amount of capital requirements that need to be set aside in order to cushion themselves against other losses in which sometimes can be catastrophic (Egidio dos Reis, A., Gaspar, R. M. & Vicente, A. T., 2009). Generally, depending on the nature and amount of risk that an insurer is taking, insurer will decide on their capital requirement. Other than that, insurer also raised their profit by investing in the financial market. Insurance companies plays a big role as one of the natural player on financial market.

Insurance companies can be exposed to two main category of risk which were insurance risks and market risk (Egidio dos Reis, A., Gaspar, R. M. & Vicente, A. T., 2009). Insurance risk are risk associated with the risk that may arise from the core business of the insurer activities such as wrong assessment of the risks insured, defaults from clients and counterparty risk from reinsurers. Besides since insurer is also an investor, therefore, they are exposed to the market risk as well. Market risk are

