

## Could South Africa's insurers be contributing to systemic risk?

In prior weeks, we looked at the subject of systemic risk, explaining its potential to damage entire financial systems and their host economies. We described an approach for assessing systemic risk in banking markets and put forward one or two quirks of South African banks. Now, we ask whether South Africa's insurers might be contributing to systemic risk. In the final piece in this series, we ask how such contribution might be detected.

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Regulation of the financial sector is typically rationalised on grounds that the financial sector is critical not just to its customers but to the wider economy as well. When it fails, the damage can extend not only to its customers but to all economic participants.

### Asymmetrical interests

Surely financial entities have an interest in self-preservation? In this sense, goes the argument, regulators do not need to protect customers against the potential for the collapse of their banks or insurers. Such a disaster is avoided by managers and shareholders at all costs.

Well, no, certainly not at all costs. Entrepreneurs take risks. In sophisticated, complex industries, the pursuit of profit may blind their awareness of the risks that they are taking. Regulators impose rules designed to protect against this, like minimum capital and governance requirements. Risk that is unique to an institution is called idiosyncratic risk. Actions to protect against this risk are collectively known as micro-prudential regulation.

For some risk, in contrast, symmetry of interest is compromised. Contagion is such a risk. Affected parties extend well beyond the entity and its customers. Regulators have a special interest in protecting against systemic risk precisely because incentives with company owners are not well aligned. The methods they use to put in place such protection are known collectively as macro-prudential regulation.

### Are insurers contagious?

Superficially considered, insurers are not systemically risky. Banks lend to one another. Insurers do not. Though they may share risks, they typically do so upwards, to reinsurers, not sideways, to one another. Banks have a reputation for off-balance sheet activity. Insurers do not, though exceptions to this saw their demise in 2008-09.

Banks are subject to substantial liquidity risk, typically linked to customer confidence. Insurers are seldom in this position, and have safeguards against it, like ring-fenced investment vehicles.

The truth is rather more nuanced. Insurer often act in concert. They sell similar products, so their liabilities are impacted by the same external factors. They deploy their assets into similar vehicles, so their assets also experience parallel movement. They invest in banks, which means that they are potentially impacted by a bank disaster. In short, they are not immune from contagion, and they might contribute to it. Next week we look at the aspects of an insurer making it more likely to do contribute in this way.

### Regulatory paradox

Before considering the question of South African insurers, we touch briefly on a fundamental regulatory challenge: the actions that regulators take to mitigate idiosyncratic risk tend to exacerbate systemic risk. The reason for this is simple. Micro-prudential regulation encourages harmonised behaviour. Entities tend to hold similar levels of capital. (Refer to the earlier paper on tipping points.) They invest in similar asset classes. They respond to crises in similar ways. Regulations can also be wrong. Insurance risk and market risk were widely considered to be uncorrelated, for example. It was assumed that they were impacted by different factors. The COVID pandemic put paid to that thinking.

Regulators reduce this risk by insisting that financial entities undertake risk management unique to their portfolios, rather than simply applying industry standards. This may go some way to mitigating the problem, but herding in the financial sector remains a serious problem that surely contributes to systemic risk.

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Do South African insurers contribute to systemic risk? On the one hand, no. They have a long history of sound prudential management. They are little involved in risky activity outside of insurance. They share significant investment risk with their customers, not necessarily a good thing for the customers, but good for reducing contagion. And they have been subject to improving regulatory requirements in South Africa and to strengthening scrutiny by investors. On the other hand, perhaps. Industry concentration is high, particularly among long-term (or life) insurers. They are significantly inter-related with other market entities. And they surely have substantial common holdings in key assets. Finally, insurers are significantly exposed to fluctuations in the economic cycle and to the potentially damaging behaviour of policyholders, who tend to panic in response to economic adversity. In short, take care. **Rob Rusconi**