

Practical approach to identifying insurer contribution to systemic risk

Over the last five articles, we have looked at the question of systemic risk. We have described some of the approaches for monitoring tendencies to systemic risk in banking and asked whether South African insurers might be contributing to such risk. The answer to the question is a careful *perhaps*. Now we ask how this contribution might be identified.

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19 JUN 2026

It is generally recognised by researchers and policy-makers that insurer potential to contribute to systemic risk is lower than the corresponding potential of banks. It is also broadly agreed that such potential cannot be ignored. Insurers might add to systemic risk by virtue of their attributes, activities or behavioural responses to market developments. They may play a part in propagating such risk, even if it does not originate with them. Insurers might be adversely affected by customer behaviour, itself in response to societal triggers, that could then contribute to systemic risk.

What we need is a good system for identifying the potential for insurer contribution—in any capacity—to such risk. This article summarises a proposed approach.

Identification and organisation

First, we determine those aspects of an insurer, its behaviour or its customers that could contribute to or exacerbate systemic risk. Researchers have described dozens of candidates. Insurance regulators have highlighted the most significant. Insurers that form part of large financial groups, for example, are more likely to be systemically risky, as are those that take risk imprudently or unduly cluster assets or liabilities by type.

Next, we need a system for classifying these potential risk sources. This makes it easier to detect them in a marketplace or at a particular insurer.

Five categories; five types

The method proposed for such clustering borrows from existing practices in conventional (micro-) prudential regulation. Now, the risks associated with micro-prudential regulation, such as herding, must not be ignored but, if we can use established practices to identify systemic risks, then we should consider them.

Five risk categories are proposed. These broadly follow the structure of the insurer balance sheet:

- assets,
- liabilities,
- the relationship between assets and liabilities,
- solvency, and

- general factors.

Within these categories, we can identify several broad types of risk. These are recommended as:

- concentration risk,
- mismatches of risk to its mitigation strategy,
- poor quality of product or investment choices,
- operational risk, and
- general risk, such as strategic risk.

Not all combinations exist in practice. However, the two-level approach helps to classify those risks noted in the literature, and to identify systemic risks that we might otherwise miss. Still, subjectivity is hard to avoid. Poor product substitutability is systemically risky because it allows for pools of concentration. Is this a general problem or a liability problem? Risks associated with embedded investment guarantees might be an asset problem or an asset-liability management (ALM) concern. If the framework helps to identify risks, then it should be regarded as useful.

Application to South Africa

Finally, we sought to understand what insurers have said about their key risks. We studied 78 annual reports of seven South African insurance groups, covering the five largest life and non-life insurers. Assessing self-disclosed risk is not a perfect way to identify systemic risks in practice, but it represents a useful start. Trends in the count of identified risks were encouraging. Holding companies identified asset- and ALM-type risks more commonly than their life and non-life peers, for example. Life insurers identified mismatch risk prominently.

The gaps in this analysis represent probably the most helpful findings of the research. Some are logical: South African insurers do not identify risks associated with investment through unregulated subsidiaries, most likely because they don't exist. Others probably require more direct assessment by the regulator. Might limited substitutability be a concern in some pockets of the market? This is where private discussions between regulators and insurers matter the most.

Risk management is not easy. Identifying risks and understanding their potential to cause damage is simply hard work, how much more where these risks have systemic impact? I hope that the methods set out in this study prove helpful to the thoughtful and wise at our regulatory institutions as they help to safeguard our marketplace. **Rob Rusconi**