Insurance industry's perspective on the project on systemic risk

2nd OECD-Asia Regional Seminar on Insurance Statistics
26-27 January 2012, Bangkok, Thailand

Contents

- Introduction
- Insurance is different from banking
- Definitions
- An activity based methodology
- Appendix

G-20 has tasked FSB/IAIS to respond to emerging threats to financial stability

- Enhance financial stability through assessing the vulnerabilities of the financial system, identifying and overseeing actions to address these and promoting the coordination and exchange of information to assist this

- Develop and promote the implementation of effective regulatory, supervisory and other financial sector policies to reduce systemic risk and address information gaps

- Reduce the hazards posed by systemically important financial institutions (SIFIs)
  - Identify systemically important financial institutions (initially on a global basis)
  - Treat SIFIs appropriately through the use of policies and instruments
  - Develop appropriate resolution frameworks

The insurance industry is pro-actively engaging in the ongoing debate on systemic risk to ensure the stability of the financial system

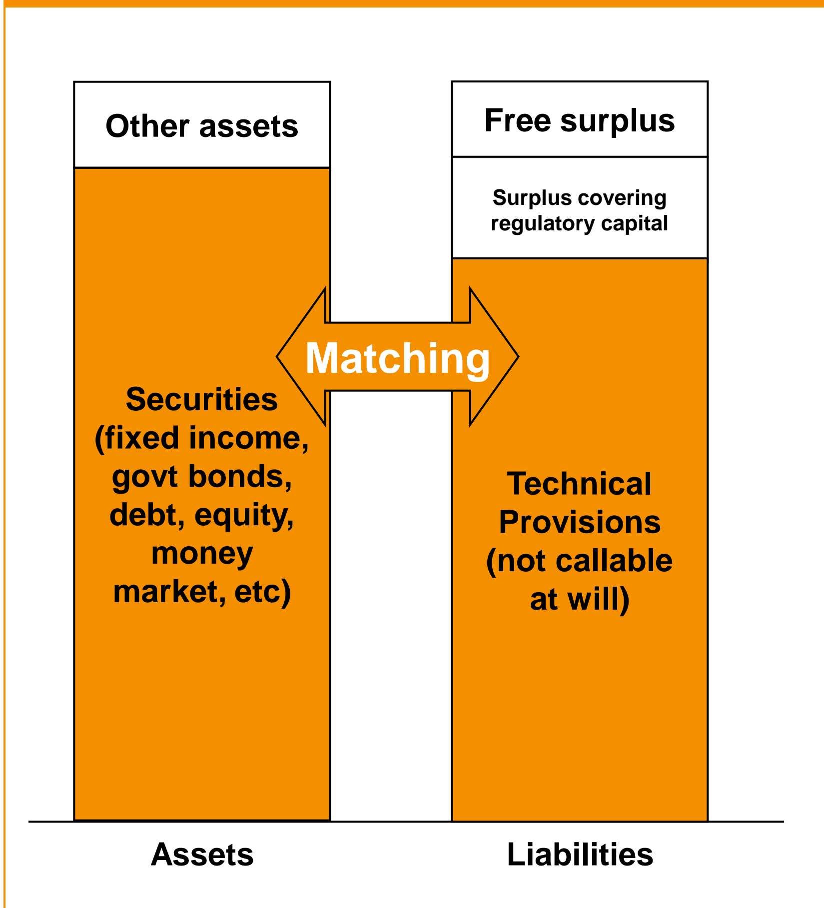
Important to remember: Insurance and banking have different roles

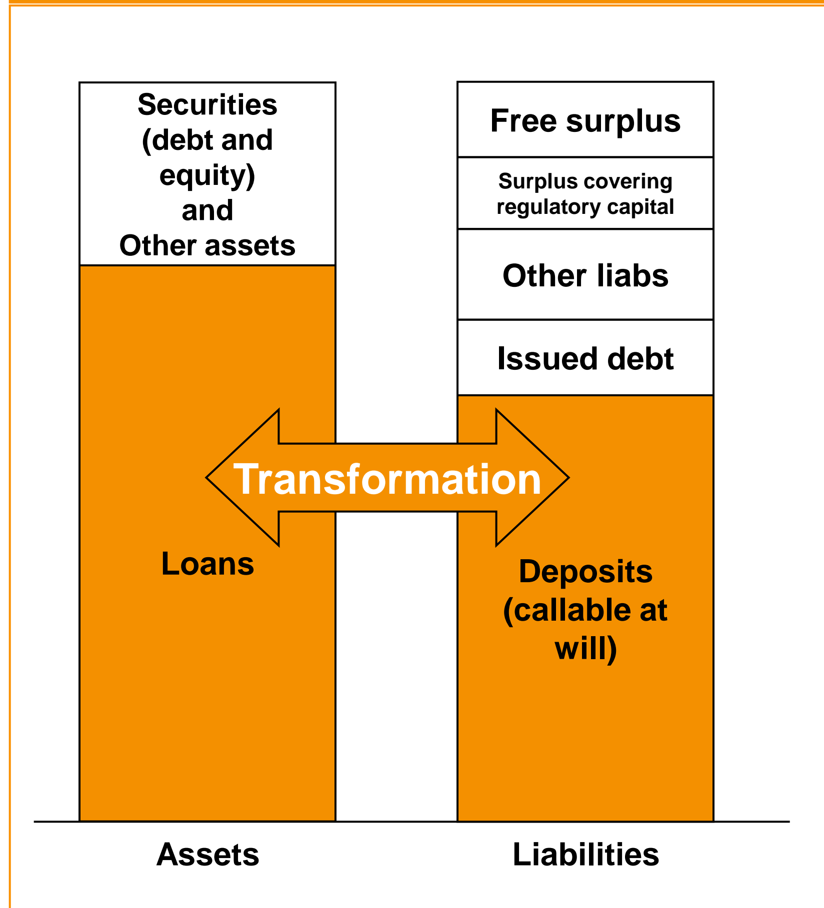
- It is essential to understand that
  - Insurance acts to provide protection by accepting risks from policyholders, pooling these risks and managing them actively
  - Banking acts to run systems that underpin the economy, such as the payment system and credit facilities
- **Insurance activities** are:
  - **funded by up-front premiums**, giving insurance **robust operating cash-flow** without requiring wholesale funding
  - **not subject** to potential **immediate cash calls**
  - **matching assets and liability** closely
  - Whereas, **banking** activities **involve maturity transformation**[1]
- **Risks** in insurance and banking activities **differ fundamentally**
  - Insurance underwriting risk is **idiosyncratic** and, for the most part, **independent of the economic cycle**
  - In contrast, banking risks tend to be **highly correlated** with the **economic cycle** and are at **risk of runs** during times of crisis

The times, timing and geography of stress in the banking and insurance industries are fundamentally different

1. Maturity transformation describes the activity of a financial intermediary that accepts deposits or investments of one term (usually short) and places those funds with a debtor in another term (usually medium or long term)

Illustrations of insurance and banking balance sheets





Maturity and liquidity transformation is fundamental to the banking business model

Matching and transformation

	Assets	Liabilities	Business type	Crisis/stress may lead to
		“Traditional insurance activities”		
(1)	Short	Short	Non life	Capital insolvency
(2)	Long	Long	Life	Capital insolvency
(3)	Short	Long	Life, Non life	Capital insolvency
(4)	Long	Short	Bank	Illiquidity (and capital insolvency)

- (1) to (3) covers traditional insurance scenarios depending on business
- (4) covers certain banking activities as maturity transformation is fundamental to their business model

Illiquidity leads to immediate intervention or failure. It is not a scenario known to insurance and thus allows for resolution over an extended period of time.

FSB/IAIS definitions and systemic risk criteria

Definition of Systemic Risk

- FSB: "The risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy."

Definition of a SIFI

"Firms whose disorderly failure. Because of their size, complexity, and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity"

Identification of potential SIFIs

Apply FSB/BIS/IMF criteria

- Size: Critical is the size of the potentially systemically risky activities
- Interconnectedness: Critical is the linkage of the potentially systemically risky activities within the financial sector
- Substitutability: Critical is the substitutability of the institutions within the potentially systemically risky activities

Additional IAIS criteria is important for insurance

- Timing: For insurance markets (and resolution of insurers) timing is a very relevant criterion

Based on these definitions The Geneva Associations developed and promotes an identification process which bases on activities rather than on companies criteria

An activity-based approach responds to the concerns regarding identifying potentially systemically risky institutions

- Targets the potential source of systemic risk
- Promotes efficient regulation and competitive markets
- Allows careful considerations of the impact on the industry
- Allows for the specificities of the insurance industry

It has other advantages:

- Globally applicable – not subject to differences in accounting standards
- Captures business below any designated “size threshold”
- Captures off balance sheet activities
- Regular reassessment captures changes in behaviour and new activities
- Reduces regulatory arbitrage
- Promotes risk-adequate pricing and therefore risk-relevant behaviour

The Geneva Association has proposed the following approach to identify systemically risky institutions

Phase I on activities

1 Review risk activities
- Review activities, which are conducted by insurers (refer to Geneva Association analysis using FSB/IAIS criteria)

2 Identify potential systemic risk activity
- Apply FSB/IAIS criteria to each activity
- Identify which activity is potentially systemically risky
  - Derivatives speculation/financial guarantees
  - Mis-managing short-term funding

Phase II on SIFIs

3 Define indicators for institutions
- Define indicators for insurers conducting potentially systemically risky activities

4 Identify SIFIs
- Analysis to be conducted at group level
- Consider aggravating and mitigating factors

An interesting historic precedent…

When considering the necessity to rescue Lehman Brothers, the FED described a "game plan" to consider the impact of its failure

"Patrick Parkinson, Deputy Director of the Federal Reserve Board's Division of Research and Statistics described a "game plan" on how to assess the necessity to rescue Lehman Brothers in August 2008 with

*(1) **identify activities** of Lehman that could significantly harm financial markets and the economy if it filed for chapter 11 bankruptcy protection,*

(2) gather information to more accurately assess the potential effects of its failure, and

(3) identify risk mitigation actions for areas of serious potential harm."

– Financial Crisis Inquiry, Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011

…that echoes The Geneva Association's suggested approach

There are a number of cases regularly mentioned in the context of systemic risk and insurance

- AIG – Non-core activities (in particular banking activities in its financial products subsidiary) caused the collapse and subsequent bailout of AIG
- TARP funds – Almost no insurers needed state support to survive the crisis
- Variable Annuities – Do not have any significant interconnectedness as insurer acts as an investor in the financial markets and does not offer a guarantee to other financial institutions
- Hedging programs – Protect solvency of insurers by reducing financial risk allowing efficient capital management
- Reinsurance – Does not pose systemic risk
  - Represents small portion of insurance risks (low interconnectedness)
  - Products and capacity are highly substitutable as demonstrated by recent crises
  - Reinsurance spirals are unlikely today following improvements in risk management and supervisory control and given the low retrocession volumes

Policymaker are responding more and more positively to our proposed approach

- IAIS shares our view that traditional insurance does not pose systemic risk, which includes insurance liability generation and investment activities
- IAIS categorises activities which may be conducted by insurance groups to categorise activities that could raise systemic concerns, and notes that certain non-insurance activities were revealed to be systemically relevant (CDS and large investment in illiquid securities)*
  - Traditional (not systemically relevant)
  - Non-traditional insurance activities (few, if any, non-traditional activities are systemically relevant)
  - Non-insurance activities (some of these may be systemically-relevant)

- IAIS is of the opinion that a loss of wealth due to a insurance resolution does not produce systemic risk
- In order to respond better to the insurance specificities, FSB allocated more time to determine the SIFI identification process in insurance

*see IAIS *Insurance and Financial Stability,* November 2011

Further considerations

- Efforts to identify systemically-relevant financial institutions on both an international and domestic basis need to be synchronised to ensure consistent and effective regulation
  - The IAIS plans to publish a paper in early 2012 that proposes a methodology to identify G-SIFIS in insurance, for consideration by the FSB and G-20
  - The U.S. Financial Stability Oversight Council has published a proposed rule to designate insurance and other nonbank financial companies for heightened supervision and regulation (d-SIFIs)
  - In Europe, EIOPA is responsible for solvency measures, ESRB for stability measures
  - Domestic policy-makers and regulators will follow at their own pace

- Banking G-SIFIs have already been published, insurance will follow after the IAIS proposal is completed later this year, and shadow banks the following year, all with annual updates
- The Geneva Association is researching on the consequences that G-SIFI designations will bring
- However, there is no need for undue haste, insurance timeline already extended
  - This is the first time the insurance industry is involved in systemic risk discussions thus thorough consideration of all issues remains to be carried out
  - Due to the business model, the impact of any insurance failure and resolution occurs over a long period of time, see upcoming research report from The Geneva Association

THE GENEVA ASSOCIATION Risk & Insurance Economics

Need for data on global level

- A well targeted and sophisticated SIFI designation process will highlight the need for good quality statistics for the global industry sector

- Comparable and timely information would benefit supervision of complex cross-border groups

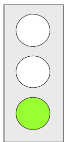
- Decisions taken can only be as good as the underlying data and information

- There are hurdles in the way which must be overcome
  - Confidentiality concerns of companies and their local or group regulator to transfer data to macro supervisory body
  - Data validity and comparability, different data systems and accounting authorities
  - Who is doing what?
  - Industry is not supportive to additional data collection process

Appendix

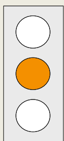
Phase 1: Geneva Association March 2010 report identified two activities that could be systemically risky

Derivatives activities



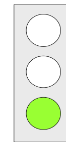
Derivatives hedging (for risk management purpose)
- Insurers enter into derivatives activities to hedge market risks and address volatility
- Positions captured in economic capital assessment and supervisory oversight
- Companies post collateral and positions captured in liquidity assessment

Asset replication

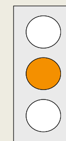


Derivatives speculation/financial guarantees
- Writing derivatives in non-insurance legal entities for speculative purpose
- Positions neither captured in economic capital assessment nor supervisory oversight
- Margin call to exceed liquid financial resources of very large trading book
- Financial guarantees: Monoliners connected to financial system through credit rating of securities

Short-term funding activities



Treasury/Funding activities
- Capital raising and long-term debt funding
- Securities lending for insurance activities only
- Liquidity risk framework and stress tests in place
- Appropriate disclosure



Mis-managing short-term funding
- Funding risky illiquid assets-through short-term debt or securities lending collateral
- Excessive risk-taking within short-term assets and cash equivalents

Aggravating and mitigating factors

- Internal risk control
- Posted collateral
- Supervisory oversight

Phase 2: Risk indicators for derivatives speculation/financial guarantees (1/2)

Quantitative indicators (all indicators must be triggered)

Size

Market value of net written (OTC) derivatives plus add-on for stressed market environment (offset for collateral and direct counterparty trades)

Interconnectedness

$$\frac{\text{Market value of net written (OTC) derivatives (offset for collateral and direct counterparty trades) to financial institutions}}{\text{Shareholders' equity of financial institutions}}$$

Substitutability

$$\frac{\text{Market value of net written (OTC) derivatives (offset for collateral and direct counterparty trades)}}{\text{Global (OTC) market value of derivatives (net of posted collateral)}}$$

Time

Immediate (criteria triggered)

Explanation of the indicators

- Market values are considered as the best estimate for the value of the derivative positions
  - Reflect current value if position is liquidated
- Over-the-counter derivatives considered as exchange-traded derivatives not subject to increased collateral requirements due to rating changes
- Offset for collateral reduces the exposure and hence the risk
- Threshold for size needs to be set in relation to total market
- Indicators subject to review and refinement

Phase 2: Risk indicators for derivatives speculation/financial guarantees (2/2)

Qualitative indicators

Enterprise Risk Management

- Effective risk management oversight through risk limits monitoring

Supervisory treatment

- Comprehensive group supervision capturing non-insurance legal entities

Substitutability

- Role of insurer in the respective derivatives and financial guarantees market

Data source

- Company specific data available from the individual companies' group risk management
- Market data available from public sources (BIS, national regulators):
  - Global (OTC) market value of derivatives
  - Shareholders' equity of financial institutions
- Potential difficulties with the indicator of shareholder's equity as there is limited data for certain types of financial institutions (e.g. hedge funds)

Phase 2: Risk indicators for mis-managing short-term funding (1/2)

Quantitative indicators (all indicators must be triggered)

Size

1. Market value of potential liquidity needs at the group level if all immediate positions are called

2. Market value of potential liquidity needs at the group level if all immediate positions are called minus immediate available liquidity sources

Interconnectedness / Substitutability

$$\frac{\text{Market value of potential liquidity needs at the group level if all immediate positions to financial institutions are called}}{\text{Total liquid assets held by financial institutions}}$$

Time

Positions callable within 3 months

Explanation of the indicators

- Immediate needs include short-term financing instruments, derivatives and securities lending
  - Does not include positions relating to traditional treasury activities
- Only positions with expiry date in the 'near future' lead to the obligation to settle under stress
- Threshold for size needs to be set in relation to total market
- Indicators subject to review and refinement

Phase 2: Risk indicators for mis-managing short-term funding (2/2)

Qualitative indicators

Enterprise Risk Management

- Effective risk management oversight through liquidity risk framework in place

Supervisory treatment

- Comprehensive group supervision and effective disclosure

Substitutability

- Role of insurer in the respective liquidity market

Data source

- Company specific data available from the individual companies' group risk management
- Market data available from public sources (BIS, national regulators):
  - Total liquid assets held by financial institutions
  - Potential difficulties with this indicator as there is limited data for certain types of financial institutions (e.g. hedge funds)