



International Association for the  
Study of Insurance Economics

# Études et Dossiers

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## Études et Dossiers No. 304

**2<sup>nd</sup> International Insurance and  
Finance Seminar of  
The Geneva Association**

**Hosted by AVIVA plc**

10 – 11 November 2005  
London

December 2005

**Working Paper Series of  
The Geneva Association**

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Layout & Distribution: Valéria Kozakova

# Trends in the Markets and in Bank Regulation and the Implications for European Insurers

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FINANCIAL MARKETS



## Introduction

00 MONTH 2004 November 2005

- This presentation reviews key trends in Financial Markets and in bank regulation that affect insurance capital
  - Broad definition of capital (i.e. both capital issued and capital created via ALM)
- Key trends:
  - **Investor convergence** – assets previously bought by banks now being bought by insurers and vice versa
  - **Access to markets more international** - insurers can invest in a broader range of assets / issue in a broader range of markets
  - **Increased liquidity in derivatives vs cash market** – more risks can be hedged
  - **Coming supply of assets from banks as a consequence of Basel 2** - more for insurers to invest in
  - **Continuing opportunity to arbitrage bank and insurance regulations**
- All these matter for the ability of insurers to:
  - Create capital via ALM
  - Issue capital
- In the remainder of the presentation we:
  - Look at trends in more detail
  - Summarise implications for insurers

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Trends in the European capital markets 00 MONTH 2004 November 2005

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Investor convergence: case study – leveraged loans 00 MONTH 2004 November 2005

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■ Non-bank share of the leveraged loan market has been rising since the mid 1990s in the US, and Europe is finally playing catch-up. Reflects both banks' increased bond holdings and institutional investors' willingness to buy attractive assets not in bond format

Year	US Non-banks (%)	Europe Non-banks (%)	Potential Market (%)
1994	29%		
1995	29%		
1996	36%		
1997	40%		
1998	37%		
1999	49%	3%	
2000	55%	8%	
2001	62%	13%	
2002	68%	18%	20%
2003	76%	20%	20%
2004	75%	25%	40%
RBS 2005 Est.			

Potential market = total institutional funds available. Actual amount invested less because institutions typically prefer higher yielding assets, of which supply is limited

Source: RBS

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**Domestic markets becoming internationalised: case study – covered bonds** MONTH 2004 November 2005

- Introduction of covered bond legislation in new jurisdictions (e.g. currently being introduced in Sweden, Finland and Norway) is a key driver of covered bond issuance
- Other attractions include:
  - Attractive pricing
    - ◆ In absolute terms
    - ◆ In current market conditions, using covered bonds alongside subordinated debt may for some issuers be a more efficient source of funding + capital than securitisation
  - Ease of execution
- Many banks now deliberately originating business with characteristics suitable for covered bond funding

**Volume of covered bonds issued outside Germany 2000-2005**

Source: Bondware

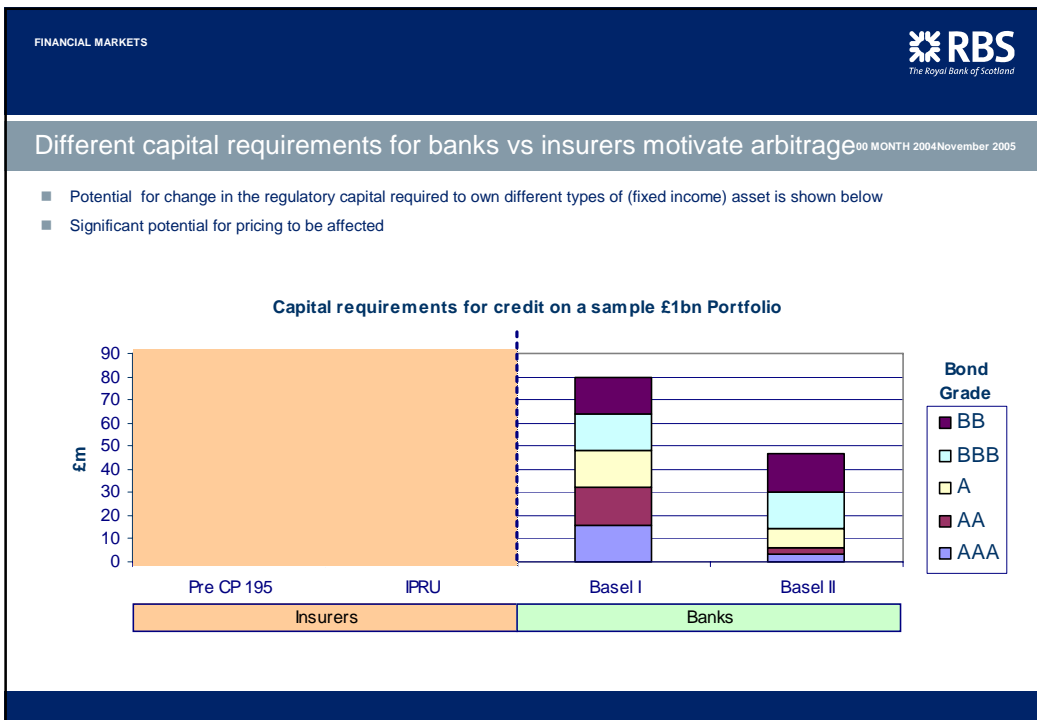
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**Assets increasingly traded synthetically: case study – German corporate credit** MONTH 2004 November 2005

**Liquidity in cash bonds vs. CDS for German corporate credit**

Source: RBS

- According to ISDA, notional amount of credit derivatives outstanding grew by 48% in H1 2005, to \$12.4trn
- 128% annual growth
- Growth of CDS market goes hand in hand with development of synthetic CDOs
- CDO market has steadily evolved to CDO-squared, CLO, CDO of ABS, etc
- Alongside this growth, regulatory pressure on UK insurers to mitigate previously unmeasured risks encourages derivative solutions
- Ability to re-package loans into CDOs, and ability to hedge loan assets, encourages new investor groups into loan market



## Implications for insurers

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- Historically, banks (especially investment banks) have generally been the most sophisticated financial risk managers. The gap vs insurers is likely to close
- Insurers are also becoming more bank-like
  - Creating fungible capital across the business
  - Taking the broadest range of assets and converting to match a fixed liability portfolio
- **Implications:**
  - Insurers will need to understand and manage much more complex financial risks
    - ◆ Investment in systems and expertise required to thrive
    - ◆ greater potential for value creation / destruction through financial risk management
  - The main constraints on insurers' management of financial risks now likely to be legal / regulatory, not market