



# **IAIS and FSB project on systemically important financial institutions (SIFIs)**

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**IAIS Financial Stability Committee Hearing, Kansas City  
Thursday 5 May 2011**



# The insurance industry is keen to continue providing input into the systemic risk debate however it is concerned with current developments

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- Industry is concerned that the approach currently being considered
  - Focuses on institutions rather than activities and therefore does not target the potential sources of systemic risk: the risky activities
  - Applies a methodology that is not designed for the industry it covers
- Great concerns that insurance specificities are not sufficiently taken into account
  - Core insurance activities are not systemically risky
  - The Geneva Association work has highlighted two non-core activities that could potentially be systemically risky
- The consequences of applying a flawed methodology
  - Risks **missing** institutions that are carrying out systemically risky activities
  - Risks **including** institutions that are **not** carrying out systemically risky activities

**We are concerned that the current proposals may distract attention from the seeds of a future crisis**



# SIFI identification process needs to be appropriately adapted for insurance

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## An activity-based approach responds to the industry's concerns regarding identifying potential SIFIs

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- Targets the potential source of systemic risk
- Allows for the specificities of the insurance industry
- Allows careful considerations of the measures to be implemented and the impact on the industry
- Promotes efficient regulation

### **It has additional advantages**

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

# The Geneva Association has proposed the following approach to identify SIFIs

## Phase I on activities

1

Review risk activities

- Review activities that are conducted by insurers (refer to The 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 (refer to The Geneva Association contribution to IAIS Observer meeting on 17 February 2011 for further details)

4

Identify SIFIs

- Analysis to be conducted at group level
- Setup of macro-prudential surveillance and micro-prudential supervision with consideration of existing regulatory frameworks
- Consider aggravating and mitigating factors (e.g. supervisory regime, resolution, etc.)



# Response to areas of concern regarding the interpretation of FSB/ IAIS criteria to insurers

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# No systemic interconnectedness with banks via bonds or equities

## Insurance investments into banks

- Investments of insurers into banks are significant (bonds)
- Just like any other (financial or other) company, insurers would be affected negatively by bank failures
- Insurers would be victims of a systemic risk event, not the cause of it
- Even if a company were to fail due to its bank investments, the resolution mechanism would spread the impact over time

## Banks exposure to insurance bonds and equity

- If banks are massively exposed to other financial institutions, their failure would of course be felt
- However: Banks' exposure to the insurance industry via bonds or equity has by no means a systemic dimension
- Investments into insurance bonds and equities are only a almost negligible fraction of total bank investments
- This type of interconnectedness is a banking regulation question not an insurance regulation question

## Derivatives/CDS

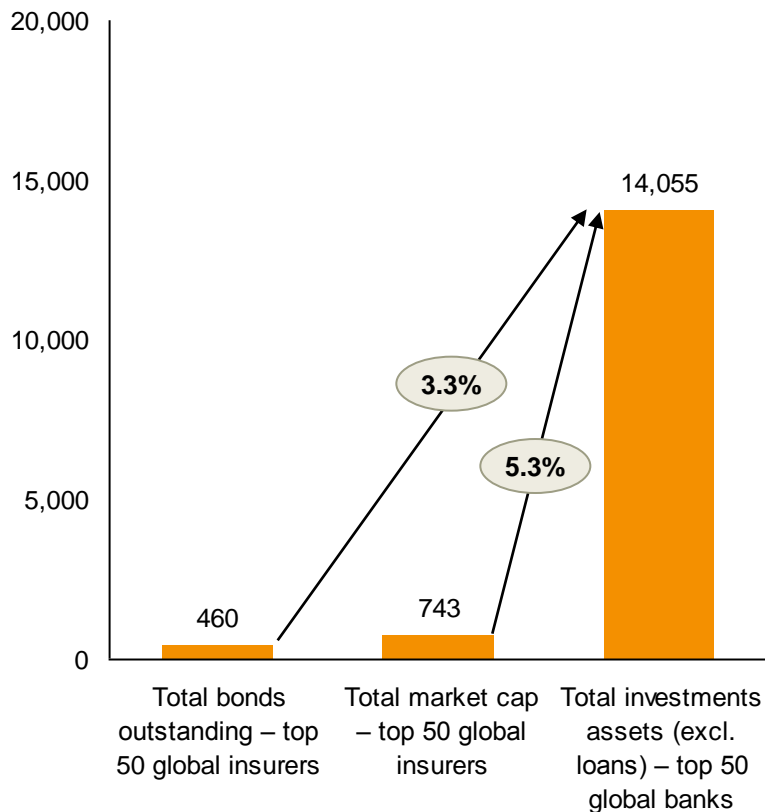
- Potential of derivative transactions to bring stress to counterparties depends on dimension of activities
- Insurers' activities on the derivatives market are in general relatively small (compared to banks)
- Insurers' core use of derivatives dealing is largely for hedging purposes
- CDS speculation as non-core insurance activity, if conducted on large scale without proper risk management can be potentially systemically relevant

## Securities lending

- Especially given an insurer's long-liquidity position, these activities can be reasonable and value-adding
- Difficult to conceive how an insurer could mismanage its balance sheet to create a liquidity risk of sufficient size to be a material threat to the financial system
- However (as shown by AIG): Mismanagement of short-term funding raised through commercial paper or securities lending has the potential to become systemically relevant

## Banks' exposure to insurance bonds or equity comparably low

**Insurers' bonds outstanding and market cap vs. Banks' investment assets, EUR BN (2009)**



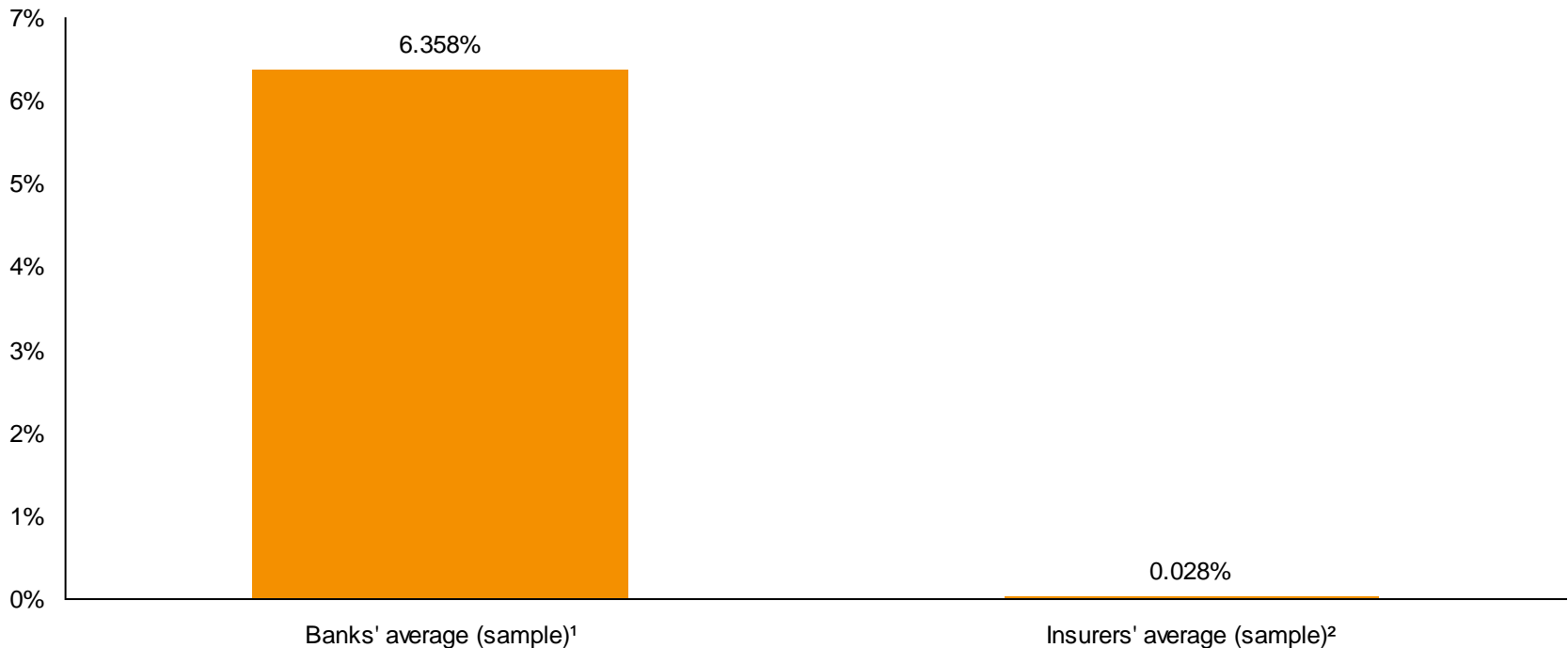
- Bank exposure to insurance via bonds limited
  - **Simplifying assumption: All insurance bonds outstanding (Top 50 global insurers) are in banks' books** (clearly overstating the reality)
  - Sum of world's Top 50 insurers' bonds outstanding would still be only ~3% of Top 50 global banks' investments
- Bank exposure to insurance via equity also insignificant for the systemic risk discussion
  - Simplifying assumption: All insurance market cap. is on books of Top 50 global banks (once again completely overstating reality)
  - Still, market cap. of Top 50 global insurers only a fraction of banks' total investments (~5%)



# Interconnectedness via derivatives? Insurers' activities relatively small compared to banks'

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**Average banks' derivatives vs. Average insurers' derivatives as % of Total OTC derivatives market, notional amount outstanding, 31.12.2009, EUR BN**



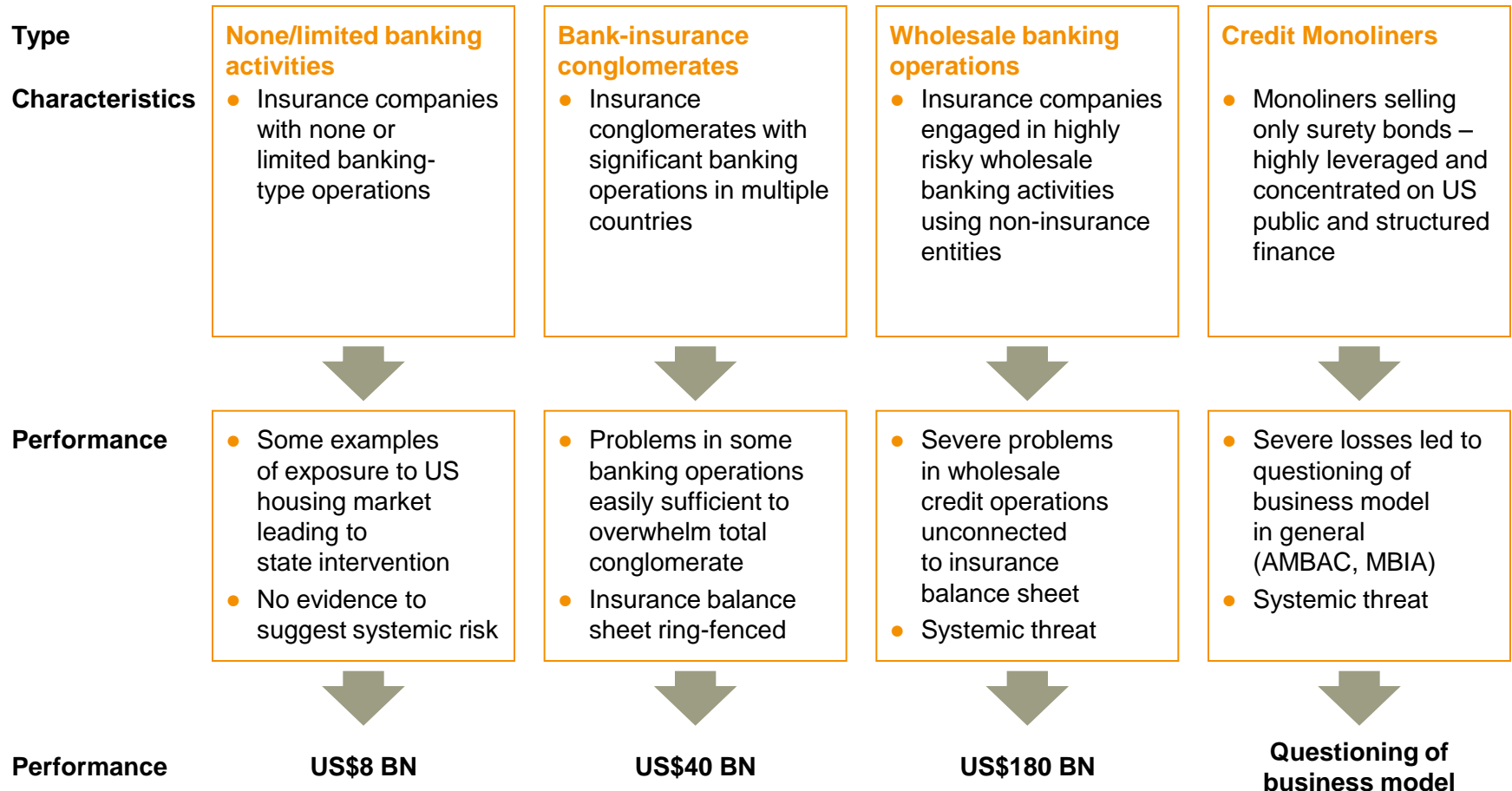
1. Sample includes JP Morgan Chase, Bank of America, Goldman Sachs, Citi, UBS, HSBC, Wells Fargo

2. Sample includes Munich Re, Swiss Re, Allianz, Axa, ZFS, Prudential UK

Source: Oliver Wyman, Company information, Bank of International Settlements

# However, insurers' engagement in banking operations can increase their interconnectedness with the banking sector

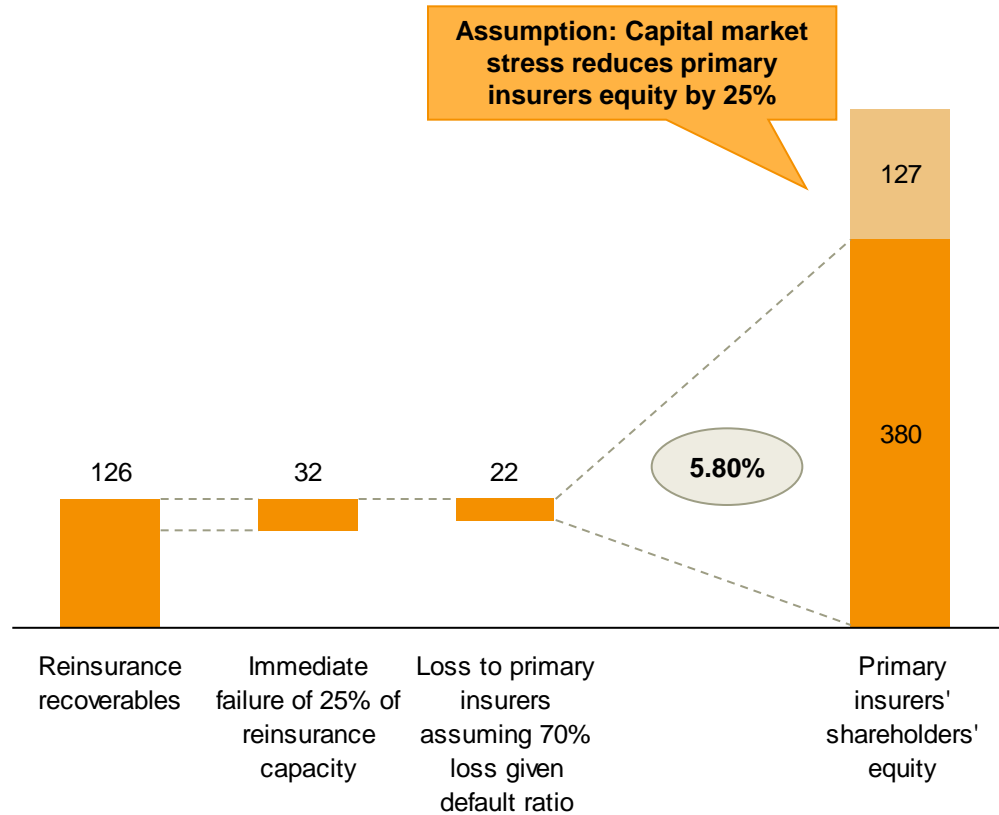
## Size and risk of banking operations within insurance companies triggered insurers' performance



1. State support reflects capital injections and asset support provided by states. Exchange rates as of 31.12.2008  
Source: Bloomberg, Company Reports, Oliver Wyman press search, Oliver Wyman analysis

# Interconnectedness via reinsurance? Even in a stressed scenario, impact of reinsurers failure on primary insurers' equity would not be systemic

Reinsurance recoverables, shareholders' equity and effects of a reinsurance failure (sample of 20 of Top 30 primary insurance groups), USD BN (2009 data)

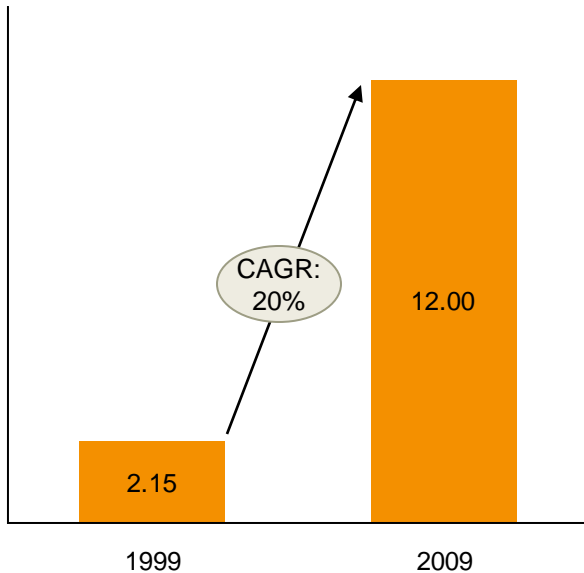


- Even in a hypothetical scenario of a reinsurance failure, primary insurers would only be **impacted to a limited extent**
- Using very conservative assumptions (capital market stress reduces primary insurers equity by 25% AND loss given default ratio is 70%), the **total loss** for the primary insurance industry of an immediate failure of 25% of global reinsurance capacity would be about **5.80% of primary insurers' shareholders' equity**
- Ratio may vary among markets/regions, but will never reach systemically risky dimensions

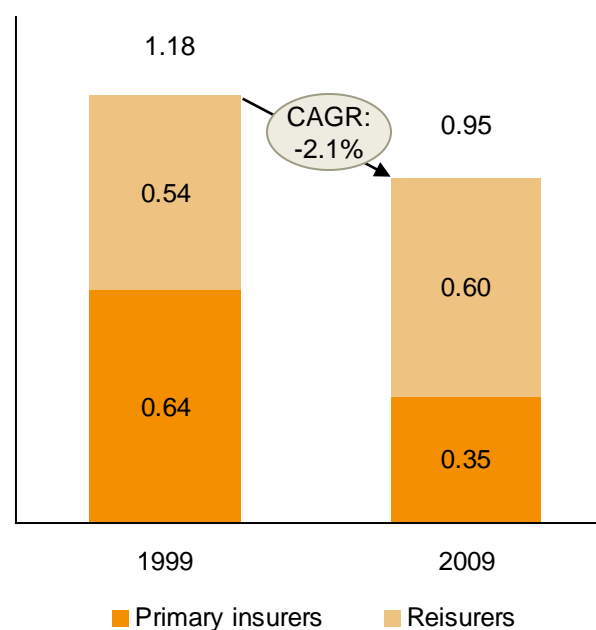
# Cat bonds/Insurance Linked Securities: No significant volumes compared to total insurance market

## Insurers' ILS exposures

Insurance linked securities in issue  
2009, US\$BN



Insurers' ILS exposures  
2009, US\$BN



- Since 1999, the ILS market has increased by 600%.
- Yet, insurers' absolute exposure to ILS has decreased: while they held 54% of ILS in 1999, their share amounts to merely 8% in 2009
- Potential future growth of ILS market to be expected, however expansion on massive scale beyond selected nat. cat. risks (comparable to MBS/ABS market) highly unlikely due to need for standardisation
- As proceeds are generally used as collateral for potential losses, ILS do not represent a liquidity risk

## 2009 ILS volumes in relation to traditional insurance

- ILS held by insurers represent 0.004% of global insurers' invested assets (US\$22,500 BN)
- ILS issuance was equivalent to 0.3% of global insurance premium volume (US\$4,102 BN)

# Questions to observers for 5 May Hearing – general remarks on interconnectedness

## Systemic risk criteria

- In general, interconnectedness is only one of several criteria of systemic risk, which all have to be fulfilled in order to qualify as SIFI
- No criterion can be singled out, e.g. interconnectedness always has to be looked at in parallel to the criteria of timing and substitutability

## Systemic risk definition

- Various questions deal with scenarios that lead to the failure of an insurer, not the potential impact of this failure
  - Only limited value in the systemic risk identification, the key question is whether failing insurers carry out systemically relevant activities, not whether they can fail (which of course they can)
- Various scenarios describe the failure of banks/insurers due to their own mis-management, and conduct of the activity to a very large scale outside the regulated entity, not due to the failure of other financial institutions
  - Only limited value in the systemic risk discussion

## Systemic risk identification and regulation

- Data collection and confidentiality
  - It is absolutely essential that confidentiality is assured during the entire process
  - Group supervisors must conduct the data collection and assessment
  - Qualitative explanations must be provided to support the data
- Many current and ongoing regulatory regimes effectively tackled the IAIS concerns on concentration risks (on investment risks, underwriting risks and counter-party risks)
- Insurers risk management practices have significantly improved over the years as the industry learned its lessons from the various crisis, illustrating the resilience of the insurance business model
- Regulatory treatment of risk activities (such as comprehensive group supervision and total balance sheet solvency assessment) and effectiveness of companies' risk management (such as ERM assessment) need to be taken into account when assessing systemic riskiness

## Timing: Impact of insurance events are of long-term nature and predictable whereas banking events happen with enormous speed and less predictability

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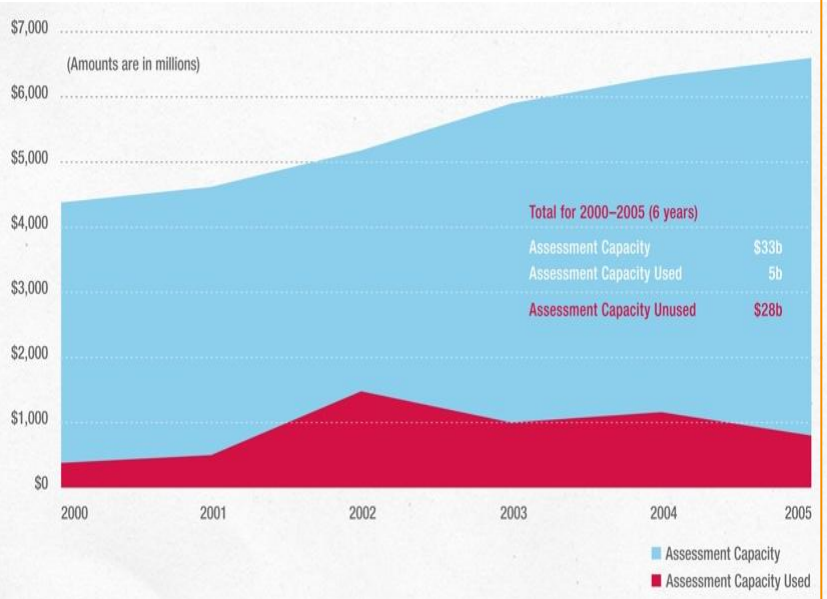
- Insurance activities are **funded by up-front premiums and not subject to potential immediate cash calls**
- Unlike banking liabilities, **most insurance liabilities are not liquid** and payment cannot be triggered by policyholders (i.e. not immediately callable)
  - Claims have to be **triggered by a valid insurable event**
  - Claims are **not paid immediately**, in particular, large catastrophic claims are paid at a different pace than in banking
- The failure and winding down of an insurer is a well understood process due to predictability of cash outflows
  - **Dampens effect of risk of contagion**
- At the time of resolution, insurance coverage would continue, rather than paying out the cash balance to the customers
  - **Long-term nature of business remains**

**The timing of insurance claims settlements reduces the risk of contagion as insurance activities are not exposed to sudden liquidity crunches**

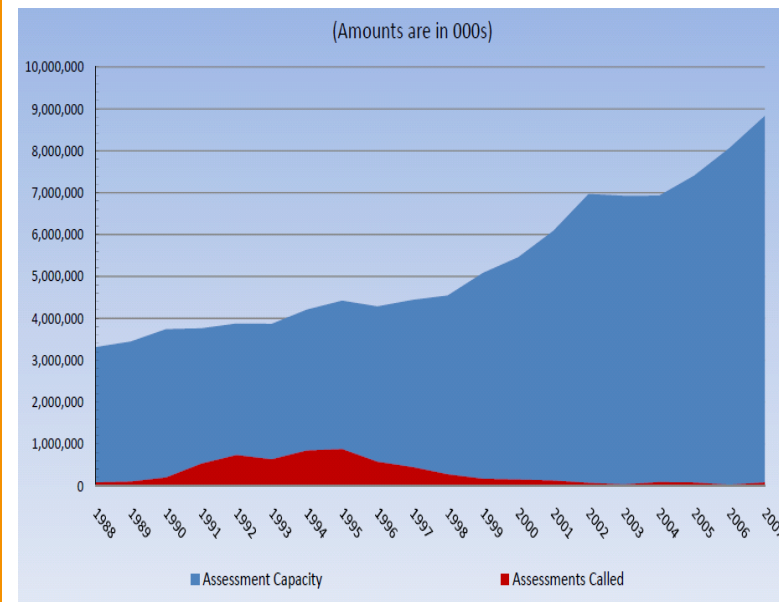


# Data provided by the Guarantee Funds Associations in the US show strong capacity to pay claimants of a failed insurer

## Property & Casualty Insurance Guaranty Fund 2000 - 2005



## Life and Health Insurance Guaranty System 1988 - 2007



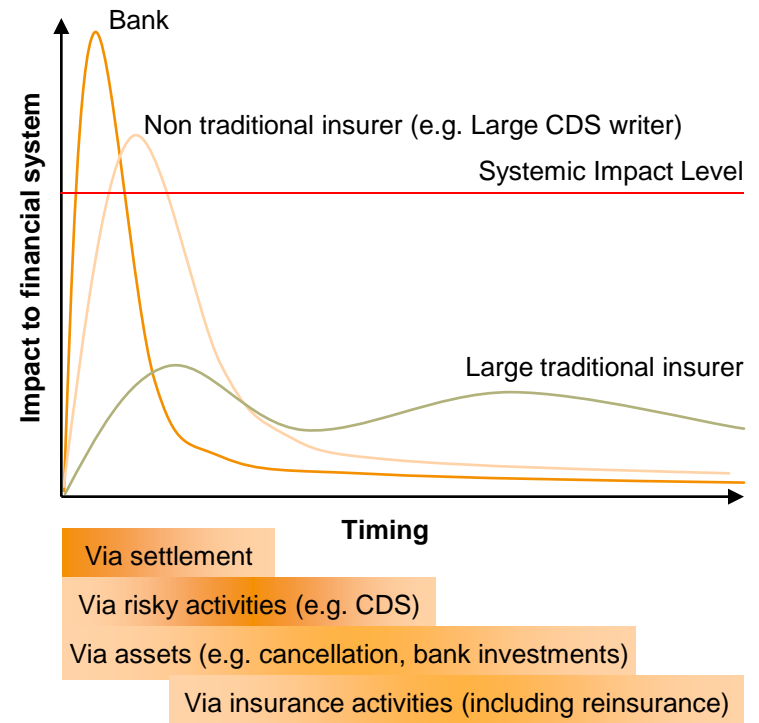
Assessments Called are the amounts actually billed to member companies that were necessary to carry out the obligations of guaranty associations with respect to impairments or insolvencies of a member insurer (i.e. Class B assessments). The amounts do NOT include administrative assessments (i.e. Class A assessments). All figures shown are for the period 1988 through 2007.

Source: National Conference of Insurance Guaranty Funds

# Timing: Long-term nature of insurance would distinguish potential impact at the time of insolvency for insurers from that for banks

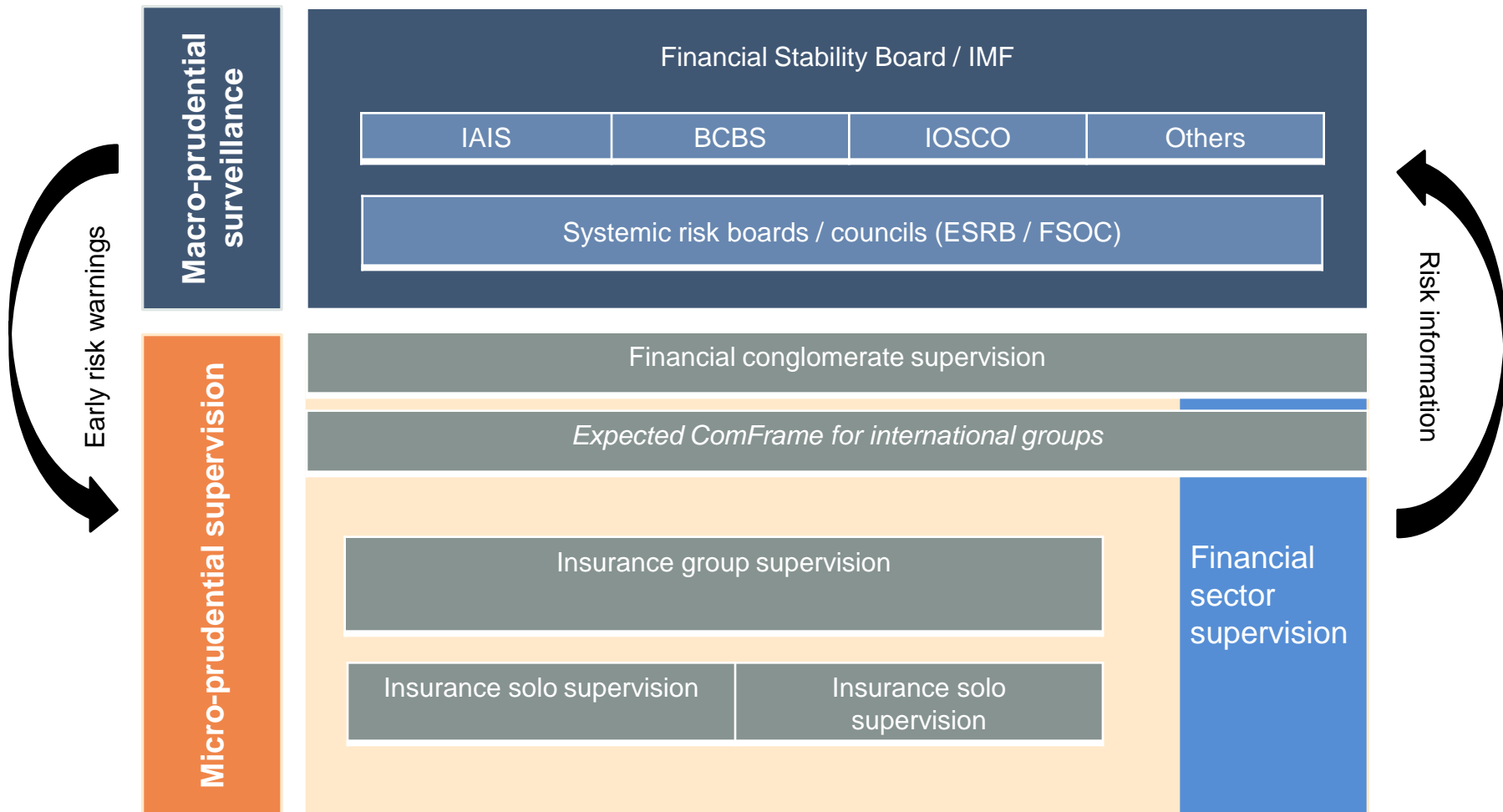
- When a bank should fail, the impact to the financial system would be materialised immediately
- Insurance is not part of settlement system, the payouts are not expected immediately at the time of insolvency
  - Insolvency would occur when assets are not sufficient to cover **future claims**
  - Insolvency will not trigger accelerated cancellation– **“no insurance run”**
    - Life – surrender penalties/non-replaceable under the same conditions
    - Variable annuities – separate accounts/revocation of guarantee/tax incentives
    - Non-life – no additional claim rights
- There may be short-term impact, if the insurer engaged in massive **systemically risky activities (SRAs) with liquidity implications (e.g. CDS)**
- When an insurer with investments in banks fails, the impact may not occur immediately
  - **Invested assets support long-term liabilities**
  - Bank subordinated loans/debts holders usually have **no right for early call**
- While an immediate substitute would be usually required for banking, it is not the case for insurance
  - **Loss of coverage would not be immediate**

## Timing of potential impact to financial system Failure of banks and insurers assuming similar size of failure [conceptual image]



**Unless engaged in SRAs, impact of insurers’ failure would be spread over the long time period and would not reach at any given time the level assumed for G-SIFIs**

# Striking the right balance: macro-prudential surveillance versus micro-prudential supervision





# Next steps

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## Transparent and timely debate on methodology and measures will provide appropriate solution for insurance

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- To date, there has not been adequate and transparent debate at the national and international level as to whether potential systemic risk issues in insurance are best addressed through G-SIFI designations
  - May need to reconsider the approach and the methodology to identifying systemically important financial institutions with insurance activities
- Nor has there been sufficient consideration of the consequences that G-SIFI designations will bring
  - Carefully assess consequences of identifying groups as insurance SIFIs
- However, there is no need for undue haste
  - No core insurance activity has ever caused a systemic financial crisis
  - 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