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Potential for Systemic Risk in the Insurance Sector (Insurers, the Natural Shock Absorbers)

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Main Issues at Stake

1. Volatility and Pro-cyclicality of IAIS Market-Adjusted Balance Sheet (BCR and ICS)

2. Use of IAIS's current Non-Traditional/Non-Insurance Activity (NTNI) Definition as a Proxy for Systemic Risk

3. Impact of BCR Volatility and NTNI Definition on the IAIS's Higher Loss Absorbency Proposal

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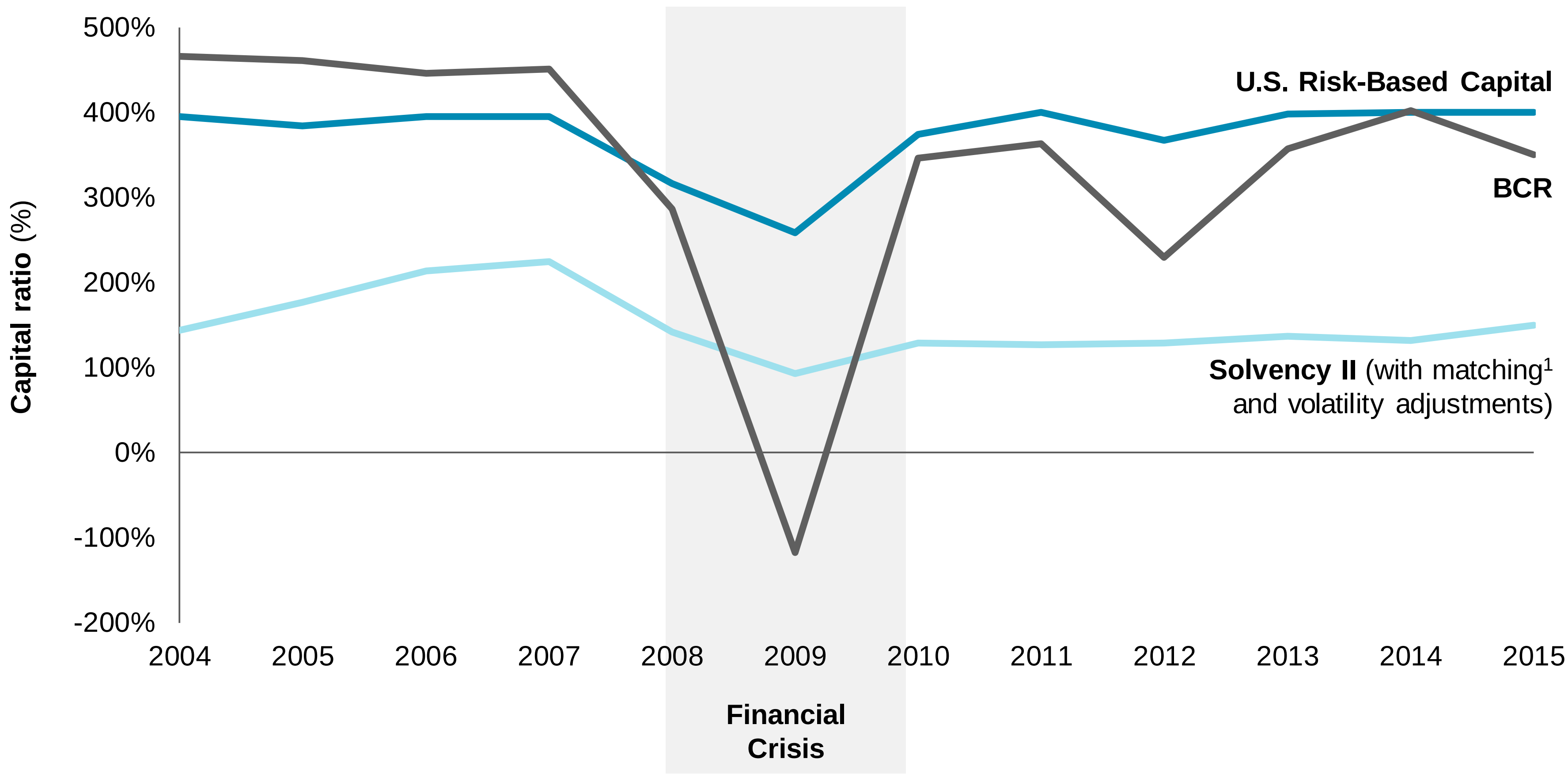
The market-adjusted valuation approach used by BCR is significantly more pro-cyclical than the U.S. Risk-Based Capital and Solvency II frameworks

Capital ratios for illustrative insurer under alternative solvency frameworks

Based on 2004 to 2015 market conditions



Notes: Based on analysis of hypothetical insurers with capital levels under 2015 market conditions set to 400% for U.S. RBC, 350% for the BCR, and 150% for Solvency II. See Appendix for further details on modeling assumptions.

1. Applied to 25% of the portfolio. 2. Based on average impairment rate for long-term investment assets at 10 largest U.S. insurers. Impairments prior to 2008 estimated (no available data).

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The elevated pro-cyclicality in the BCR arises from a disconnect between its allocation of credit spread to the liability discount curve and asset valuations

Topic	BCR	Solvency II	U.S. RBC
1 **Liability discount curve**	• Market-based discount curves • Includes 40% of 10-year investment grade corporate spread	• Market-based discount curves • Allows for matching & volatility adjustments	• Book-value approach • Specified discount rates
2 **Asset valuation**	• Fair value (financial instruments) • IFRS or GAAP (other assets)	• Fair value (all assets)	• Book value (most assets)
3 **Required capital**	• Factor-based approach • Exposure metrics include current estimate liabilities and fair value assets	• VaR-based capital • Standard formula with pre-defined shocks	• Factor-based approach with exceptions (VAs) • Exposure metrics include book value liabilities and assets

Differences in treatment drive pro-cyclicality

We propose two simple refinements to the existing approach to the credit spread adjustment to reduce the pro-cyclicality in the BCR framework

Process for determining credit spread adjustments

= Components with proposed refinements

Determine eligible assets on which to measure spreads

- Determine a prudent basket of eligible assets on which to measure credit spreads
- E.g., investment grade corporate bonds & sovereigns

Measure gross spreads of eligible assets

- Measure the G-SII holdings across the eligible assets
- Determine the weighted-average spread of these assets
- *Can define either a single spread (parallel) or spread term structure for each currency*

Apply pass-through rate to gross spreads

- Include in the discount rate a fixed proportion ("pass-through rate") of the credit spread
- Pass-through rate should produce a tolerable level of pro-cyclicality

1 **Define basket of assets based on the typical credit quality of G-SIIs' portfolios**

2 **Determine pass-through rate to align pro-cyclicality with existing solvency framework**

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The current definition of NTNI is a poor proxy for systemic risk

IAIS has outlined three principles to identify NTNI Activities

	1	2	3
	Credit guarantee principle	**Market & liquidity risk principle**	**Shadow banking activity principle**
Definition	Products that **provide credit guarantees to financial products**	Products that expose the insurer to **substantial market and liquidity risk** and require **complex risk management**	Capital market activities that result in **maturity or liquidity transformation, leverage, or imperfect transfer of credit risk**
Rationale	• Vulnerability to systemic risks / shocks to overall economy	• These products increase reliance on derivatives and interconnectivity • Includes products with performance guarantees	• Aims to captures "shadow banking" investment activities

Do these principles reflect systemic risk?

Source: Global Systemically Important Insurers: Policy Measures (18 July 2013).

Impact on Higher Loss Absorbency of BCR and NTNI

- The HLA proposal will be fundamentally flawed unless the issues with the BCR and NTNI are addressed:
  - Seeks to calibrate capital requirements (via 33% uplift) without first addressing issues in the underlying framework
  - Builds off a flawed NTNI definition
    - Bucketing relies on G-SII Scores (45% NTNI)
    - HLA charge could target NTNI
- The proposal should be delayed to resolve these issues and avoid a “once written/always true” path forward
- If not delayed, current proposal should be recognized as flawed and subject to substantial change

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Conclusion: It is time to press the “pause” button and fix the flaws

- Appropriately address BCR pro-cyclicality
- Redesign the G-SII assessment methodology to reflect:
  - Absolute (vs relative) levels of risk
  - Residual (vs inherent) systemic risk
- Determine the best mitigation tools for these risks – e.g., capital, stress testing, or other regulatory measures
- Apply these tools to ***all*** companies engaged in those activities deemed to exhibit systemic risk