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

**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).
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.

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

- **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
IAIS has outlined three principles to identify NTNI Activities

1. **Credit guarantee principle**
   - Definition: Products that provide credit guarantees to financial products
   - Rationale: Vulnerability to systemic risks / shocks to overall economy

2. **Market & liquidity risk principle**
   - Definition: Products that expose the insurer to substantial market and liquidity risk and require complex risk management
   - Rationale: These products increase reliance on derivatives and interconnectivity
     - Includes products with performance guarantees

3. **Shadow banking activity principle**
   - Definition: Capital market activities that result in maturity or liquidity transformation, leverage, or imperfect transfer of credit risk
   - Rationale: 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
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