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Financial regulation –
Stability versus Uniformity

Session 3: Potential for systemic risk in the Insurance sector?

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Why a '?' when speaking about potential for insurers' systemic risk?

- When functioning properly, insurance actually contributes to financial stability
  - Insurers are valuable providers of **stable long term funding**
  - They offer services which benefit the real economy by allowing the **transfer and efficient management of risks**
- However, under some circumstances, insurers can be sources or amplifiers of systemic risk
  - They finance large parts of the non financial sectors (sovereign) and financial sectors (banks) and could transmit a large default as investors
  - They insure crucial parts of the economy and the failure of a large provider of insurance services may impair sectorial activity (ex: marine insurance)
  - The reinsurance network potentially increases interconnectedness
  - Non traditional non insurance activities proved specifically risky for insurers
  - The IAIS identified **9 systemic insurers** with a methodology adapted from the FSB filter (Size, Complexity, Interconnectedness ➔ Size, Global Activity, Interconnectedness, NTNI activities, Substitutability)

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Recent developments for global insurance regulation

- The list should be updated in Autumn 2015
  - For insurers only

- Some remaining issues still to be tackled
  - **The inclusion of the reinsurers in the list**
    - For level playing field purpose
    - As groups often run both insurance and reinsurance businesses
  - **Transparency on data**, as for the banking sector
    - Transparency on the method used to designate G-SIIs
    - Public disclosure on the data used in this methodology/ of the results on which the designation is based
  - **The definition of NTNI**
    - To include all possibly procyclical products (e.g. trade credit insurance, indexed products)
  - **The measurement of interconnectedness**
    - The extension to systemic insurers of current banking data collection

Recent developments for global insurance regulation

- The identified insurers are subject to specific measures, especially in terms of **resolution**
  - Enhanced group-wide supervision
    - Through cross-border agreements between supervision authorities
    - Supervision powers on the holding for the lead resolution authority
  - Establishment of a Crisis Management Group
    - Done by July 2014
  - Development of a Systemic risk management plan
  - Development of Recovery and Resolution Plans, including
    - A resolvability assessment
    - And a Liquidity risk management plan

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Recent developments for global insurance regulation

- The identified insurers are subject to specific measures, especially in terms of capital requirements - **HLA** (higher loss absorbency, based on the BCR).
  - Concept validated
  - Ongoing negotiation on the calibration of the HLA and on the assets eligible to meet this requirement
    - HLA shall be related to the degree of systemic importance of each G-SIIs
  - Strict timeframe imposed by the FSB:
    - Agreement on the formulas by 2015
    - Confidential calculation of BCR/HLA during three years (2016-2018)
    - Full implementation of BCR/HLA starting in 2019
  - BCR is not very risk sensitive → it is a first step.

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Beyond the identified G-SIIs

- **Other potential for systemic risk : poor visibility** on differences between regulatory frameworks
  - Need for an harmonization of the regulations to:
    - Enhance the comparability between markets, then ensure a better level playing field : “same risks, same rules”
    - Decrease the risk of regulatory arbitrage
    - Taking into account national products and markets specificities and including if necessary transitional periods
  - Initiatives at the international level
    - Publication of the Insurance Core Principles, basis for the countries assessment by the IMF
    - Development of a Common framework (ComFrame) for the supervision of the internationally active insurance groups (IAIGs), including an International Capital Standard (ICS) aiming at replacing the BCR
    - Discussion on IORP 2: an opportunity to increase transparency for pension funds towards members, beneficiaries and employers and to harmonize governance rule
  - Experience from the European negotiations of Solvency II and Omnibus II
    - The design of harmonized rules is a very long process
    - Need to take into account the on-going developments of the financial market and of the regulation

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Beyond the identified G-SIIs

- Potential for pro-cyclical behavior which can amplify financial markets or real economy cycles

  - Amplified with a regulation based on market valuation
    - In Solvency II, the so-called Long term Guarantee package has been adopted to smooth the effect,
    - but then we get a distorted view of the market valuation and this biases the level-playing field as some measures are country-specific or undertaking-specific

  - Yet only can market valuation properly catch specific risks such as market risk
    - SCR followed at the sub-module level

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Financial conglomerates and systemic risks

- Can insurers become systemic by their belonging to a banking group (financial conglomerate)?
  - In Europe, conglomerates mostly have a banking head.
  - The insurance subsidiary of a bank conglomerate adds to its market footprint
  - The crisis provided some evidence of intragroup contagion from banks to insurers

- The directive on Financial Conglomerates adresses the specificities of this type of entities at the micro-prudential level
  - Implementation of a supplementary supervision, and a strong collaboration between supervisors
  - In order to prevent double or multiple gearing
  - Not operational worldwide to take into account insurance subsidiary in pillar I for macro-prudential purposes

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