CHALLENGES IN ADDRESSING POTENTIAL SYSTEMIC RISK IN INSURANCE

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Reflections on the systemic regulatory framework and process

The FSB seeks to control systemic risk in “non-traditional” insurance activities of companies identified as “systemically important” through a capital surcharge.

Open issues:

1. The designation methodology of systemic companies is not stabilised.

2. Size is penalized while it is a factor of stabilization in insurance.

3. The “systemic risks” to be addressed are not identified.

4. The concept of “non-traditional” insurance is not defined.

5. The capital proposal is volatile and procyclical.
Risk management as of today: European perspective

Solvency II

- Capital based on a stress scenario to withstand 1/200 year shock
- Risks covered:
  - Market risks incl. Equity risk, Credit risk, Currency risk, Spread risk
  - Counterparty default risk
  - Life risks: Longevity risk, Mortality risk, Morbidity risk, Lapse risk
  - Non-life risks incl. Natural catastrophe risk
  - Health risks incl. Epidemic risk
  - Operational risk

Includes: diversification, volatility adjustment, matching adjustment, long-term exposure

**plus:**

- Group supervision
- Systemic Risk Mgmt Plan
- Liquidity Risk Mgmt Plan
- Resolution Plan
- Recovery Plan
What the FSB proposes

“Basic capital requirement” (BCR) established by the FSB in 2014

\[
BCR = \alpha \left[ cap_a(\text{trad. life}) + cap_b(\text{trad. non-life}) + cap_c(\text{non-trad.}) + cap_d(\text{assets}) \right] + \text{cap}_n(\text{non-insurance})
\]

Proposed capital surcharge (Higher loss absorbency – HLA) formula:

\[
HLA = \alpha \beta [\gamma BCR(\text{non-trad.})+(1-\gamma)BCR(\text{trad.})] + \min(1\% RWA; \alpha \beta \cdot 1.33 \cdot BCR(\text{non-insurance}))
\]

\(\alpha\) = pre-determined factor to keep average HLA constant
\(\beta\) = G-SII scoring factor
\(\gamma\) = weighting factor

A capital surcharge based on the whole balance sheet

→ “Core-insurance activities are not sources of systemic risk” (IAIS, 2011)
→ Diversification not considered
→ Asset Liability Management not considered and volatility adjustment missing

Consequences:

→ A second and parallel capital-framework – two different compasses!
→ Financial (in)stability?
→ An unnecessary build-up of idle capital
An alternative proposal

From capital on the “NTNI” cloud...

Callable insurance contracts
Banking
CDS/CDO underwriting
Alternative risk transfer (ART)
Repos

Callable contracts
Derivatives
Finite reinsurance
Variable annuities

Mortgage guarantee insurance
Financial guarantees insurance
...