# 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**

$$BCR = \alpha\,[\,cap_a(trad.\ life) + cap_b\,(trad.\ non\text{-}life) + cap_c(non\text{-}trad.) + cap_d(assets)] + cap_n(non\text{-}insurance)$$

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

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

$\alpha$ = pre-determined factor to keep average HLA constant
β = G-SII scoring factor
γ = 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

Derivatives

CDS/CDO underwriting

Alternative risk transfer (ART)

Repos

Mortgage guarantee insurance

Banking

Financial guarantees insurance

…

Finite reinsurance

Variable annuities

…

**…to a business-model approach:**

## Insurance products

*Callable contracts, VAs, …*

## Products management tools

*Derivatives,…*

## Balance sheet management tools

*Securities Lending, Repos…*

## Non-insurance activities

*Banking, leverage and maturity transformation activities…*

**Systemic risk control through:**

1 Risk Management guidance

2 Collateralisation

3 Liquidity requirements

Capital add-ons