Position Paper

Insurance Europe comments on the Joint Forum's Consultative Document: Developments in Credit Risk Management Across Sectors

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Summary

Insurance Europe welcomes the opportunity to respond to the Joint Forum's consultative document on credit risk management across sectors. Insurance Europe's comments have been structured according to the Joint Forum's four recommendations.

Recommendation 1: *Supervisors should be cautious against over-reliance on internal models for credit risk management and regulatory capital. Where appropriate, simple measures could be evaluated in conjunction with sophisticated modelling to provide a more complete picture.*

Insurance Europe believes that appropriately designed and supervised internal models are appropriate tools for measurement of insurers' risk exposures. Actually, internal models represent the most accurate calculation of the company's idiosyncratic risks and exposures as it is virtually impossible to construct a standard formula that measures the risks to which large and diverse insurers are exposed in an accurate way.

Internal models are a key tool from a risk management perspective. They are integral to the business and are not used to only generate a solvency number. The allowance for internal models allows for an alignment of internal steering view with regulatory view and appropriate determination of risk, including adequate reflection of risk mitigation instruments and quantification of diversification benefits. Internal models also enable insurers to allocate capital to portfolios based on contribution to risk.

Insurance Europe supports the IAIS's position on internal models, as set out in paragraph 17.12.4 of Insurance Core Principles, Guidance and Assessment Methodology:

"Effective use of internal models by an insurer for regulatory capital purposes should lead to a better alignment of risk and capital management by providing incentives for insurers to adopt better risk management procedures which can:

- *produce regulatory capital requirements that are more risk sensitive and better reflect the supervisor's target criteria; and*
- *assist the integration of the internal model fully into the insurer's strategic, operational and governance processes, systems and controls."*

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The use of internal models was from the beginning included as a core element of the Solvency II framework, alongside a Standard Formula. The entire design of Solvency II (and in particular the high overall level of capital required by the agreed Standard Formula) was based on internal model use being an available option,

Recommendation 2: *With the current low interest rate environment possibly generating a "search for yield" through a variety of mechanisms, supervisors should be cognisant of the growth of such risk-taking behaviours and the resulting need for firms to have appropriate risk management processes.*

A persistently low interest rate environment is neither in the interest of insurers nor in that of policyholders, who find it more difficult to save enough to meet their need for financial security in retirement as real returns are diminished.

Insurers can generally withstand fairly long periods of low interest rates because of the long-term nature of their investments. However, as low interest rates lead to higher liability valuations and lower returns (even if these are expected to only last a few years) a low interest rate environment has a major effect on insurers' investment strategy. It forces them to re-evaluate this strategy for policyholders, while still achieving minimum returns acceptable for shareholders.

Achieving this double objective will inevitably require insurers to consider some combination of the following:

- Assessing the widest range of investments so that assets with attractive duration, diversification and risk/return profile can be found to match liabilities and policyholder needs – this includes for example Greater interest in assets such as infrastructure investment
- Increasing investment risk (which will also under Solvency II, lead to higher solvency capital requirements and adjustments to management)
- Changes in levels of guarantees and/or pricing for new customers
- Potentially introducing products with different design

Insurance Europe would like to highlight that the Solvency II prudential framework includes explicit risk-management requirements that apply to insurers under the prudent person principle[1], such as: *"insurance and reinsurance undertakings shall only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs."*

Recommendation 3: *Supervisors should be aware of the growing need for high-quality liquid collateral to meet margin requirements for OTC derivatives sectors, and if any issues arise in this regard they should respond appropriately. The Joint Forum's Parent Committees (BCBS, IAIS and IOSCO) should consider taking appropriate steps to monitor and evaluate the availability of such collateral in their future work while also considering the objective of reducing systemic risk and promoting central clearing through collateralisation of counterparty credit risk exposures that stems from non-centrally cleared OTC derivatives.*

While improvements in collateral requirements and reporting are strongly supported by the insurance industry, it should be recognised that the actual rules developed to address these issues (e.g. EMIR in Europe) unfortunately did not sufficiently consider the specific way in which derivatives are used by the insurance industry for hedging risk, particularly in their long-term portfolios; this will create some unintended and unnecessary costs and consequences.

Derivatives are often vital for hedging insurers' long-term liabilities and, hence, for the provision of long-term products. Recently developed rules will require insurers to cover short-term daily volatility in the value of the derivative with highly liquid collateral. In the case of centrally-cleared contracts, this will usually need to be cash, since this is the only collateral accepted by the central counterparties that the regulators want insurance

[1] See Article 132 of Solvency II

companies to use for the majority of their derivative transactions. This will force insurers either to hold excessive amounts of cash or to monetise assets via the repo market. None of the two approaches is optimal in the case of insurers with long-term liabilities that are covered by long-term quality assets.

Liquidity of collateral was defined as an objective by the BCBS and IOSCO as part of their global requirements for OTC derivatives. The implementation of this objective remains at a very early stage. In Europe, for example, recent proposals linked liquidity to concentration limits to be applied to assets that are part of a collateral pool. Insurance Europe raised concerns on the initial European proposals and provided supervisors with examples where in practice such limits would not necessarily address liquidity and would rather create distortions in optimal asset allocations.

Insurance Europe agrees that the recent OTC derivatives reform will create over time increased demands for high-quality and liquid collateral. While policymakers should monitor the implementation of the new derivatives rules and the way in which they can impact particular types of eligible collateral, it should be avoided that new requirements (such as concentration limits) are added to even further limit the extent to which insurers can use existing (often long-term) assets to cover collateral needs.

Recommendation 4: *Supervisors should consider whether firms are accurately capturing central counterparty exposures as part of their credit risk management.*

In its counterparty default risk module, the Solvency II framework imposes capital charges to insurers managing derivatives; such capital charges are meant to reflect exposures to both centrally cleared and OTC derivatives[2].

[2] See Article 192 of the Solvency II Delegated Acts

Background information on insurers' exposure and measurement of credit risk

Insurers can be exposed to credit risk in a number of ways. The most significant exposure for many companies is through their investment portfolio, where they invest in listed and unlisted types of debt instruments. The other most important type of exposure is through their use of risk mitigation instruments such as reinsurance and derivatives.

Insurers invest in debt instruments in order to match liabilities and the use of long-term debt is of particular importance given the often predictable and very long-term nature of these liabilities. As a consequence of asset liability matching, insurers can reduce or even eliminate the risk of forced sales on assets, can choose when or if to sell the debt or can choose to hold to maturity. This means that in many cases the primary exposure that insurers have when holding debt matching liabilities is to losses on actual defaults (as defined in Box 1 of the consultation). In some cases, however, insurers can be exposed to forced sales of assets, in which case they will be exposed to changes in the market price of debt instruments.

It is clear that the exposure through use of reinsurance and derivatives is a counterparty risk type default and is measured as such under Solvency II. In the case of debt however, Solvency II assumes that all companies are exposed to credit spread risk for all their debt type of investments except for mortgages, which are treated as a counterparty default risk, taking into account the level of recoveries possible from the property collateral.

The industry has pointed out that assuming all other debt investment is exposed to spread risk ignores the impact of the long-term liabilities and effectively assumes insurers are always acting like traders. This will tend to exaggerate the real risk exposure because spread risk is generally significantly higher than the risk posed by actual default. Going forward, potential unintended consequences should be carefully considered and monitored, especially the impact on insurer's ability to invest in long-term and illiquid assets, such as infrastructure.

With respect to the additional recommendations on page 6 (Box 2) of the consultative document, Insurance Europe would point out that the Solvency II framework deals with insurers' exposure to risks related to SME loans and to reinsurance.[3]

[3] See Article 176 (4) of Solvency II (Spread risk sub-module) and Article 192 of Solvency II (Counterparty default risk module)

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