Risk management in the face of risky sovereign debt: four observations

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First, let me thank the conference organisers for the opportunity to present my own thoughts and listen to the very interesting contributions and debates so far. Before continuing with my own observations, however, let me preface my comments with the standard disclaimer: the following represents my own, personal opinion and does not necessarily reflect the opinions of Allianz SE or its associated operating companies.

For my contribution, I would like to make four observations which might be somewhat controversial, the objective being to generate an interesting debate afterwards. To put them in context, these observations reflect my own experiences over the past decade as a chief risk officer in European insurance companies that are active in long-dated life asset accumulation/decumulation products. These products have a high social value, providing individuals with security in both their working life and after retirement and allowing them to save for their retirement; however, from a shareholders' perspective, such products must be managed carefully using a long-term, liability-based investment strategy. Obviously, sovereign debt has a large potential role in such investment strategies.

1. Compelling reasons to change traditional business models

My first observation is that there are compelling reasons to change traditional insurance business models given the developments in the European sovereign debt market over the past two years.

Historically, European insurers could be characterised as holding domestic sovereign bonds for duration and other, "higher-risk" assets such as corporate bonds, real estate and equity in order to generate investment returns. This naturally led some European insurance companies to build up high concentrations in sovereign government bonds. And, more than five years ago, I would have considered this "barbell" strategy to be very prudent, one which would allow me to sleep well at night because of the perceived (and some would argue, actual) low risk profile of sovereign issuers.

Obviously, subsequent developments have demonstrated that the (near) risk-free assumption for sovereign bonds was not correct and that the strategy of so heavily concentrating assets in sovereign debt was, in retrospect, imprudent. In a 180-degree change, the prudent insurance companies of today are actually those that have run through scenarios or "war games" reflecting debt haircuts, defaults and the redenomination of sovereign debt.

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Adding salt to the wound, it is has also become apparent that sovereign issuers represent a source of risk that is highly correlated with the global financial system, most usually through their implicit and explicit backstopping of banks. This is evidenced by the high correlation between selected sovereign and bank CDS spreads. While I recognise that correlation does not imply causation, it is fair to say that a perceived sovereign problem may negatively impact the ability of some banks to secure funding and liquidity, with reverberations propagated across the banking sector and the real economy. This correlation is especially problematic for European, long-term institutional investors since a large proportion of most European fixed income indices comprise bank issuers, implying that institutional investment portfolios are both directly and indirectly impacted by perceived sovereign risk.

Adding insult to injury, the innovative monetary and fiscal responses used to stabilise investor confidence in sovereign debt and stabilise the banking sector (for example, the LTRO, "quantitative easing", secondary market bond purchases etc, activities which are often bundled under the label of "financial repression") have an additional adverse effect on insurers by driving nominal (risk-free) interest rates lower and lower. This creates a third source of pain for long-term, liability-driven investors – since assets may fall short of the duration of liabilities, lower interest rates may be economically painful for European life insurers offering long-term products

Not surprisingly, the combined effect – the direct valuation impact of rising sovereign spreads, the indirect impact on bank paper and the economic impact on our liabilities from low risk-free interest rates – has led to a strong and adverse re-rating of life insurance companies' share values. In other words, although insurers may have long-term investment horizons out of necessity based on their liability structure, their share prices are impacted immediately to these events, an impact that should not be ignored by the management of publicly listed companies.

This brings me to my first observation – *that European insurers cannot afford to be as concentrated in sovereign issuers in the future as we have been in the past*. This is not to say that they cannot invest in sovereign bonds, but rather that the high concentration levels seen in the past are no longer prudent from a shareholder's (and, in a worst-case scenario, a policy holder's) perspective. The real question is therefore, "How much is too much?"

2. Guidance from solvency regulation not likely

My second observation is that, when answering the question "How much is too much?", the industry probably cannot look towards regulation for guidance.

Although there may, in principle, be incentives under Basel II/III to consider sovereign risk from an objective, risk management perspective, I am going to let others make that case; it seems to me that, if the appropriate incentives do exist, then they are not particularly strong in practice. I note that I am not an expert in this area and that I could be wrong. However, as a casual observer, I cannot help but note that the apparently high use of LTRO funds by banks to purchase domestic sovereign debt is a surprising outcome if such risk management incentives did in fact exist somewhere, anywhere, under Pillar I, Pillar II or via a large exposure directive. Furthermore, it is not clear to me that objective, risk management incentives are likely to be strengthened anytime soon given the almost "symbiotic" relationship between some sovereigns and their banking systems.

Turning to the insurance industry, I am not sanguine about the incentives here either. Such incentives do not seem to exist under the current Solvency I framework and, based on the recent drafts of Solvency II and "reading the tea leaves", I do not see a high likelihood of any stronger incentives in this regard emerging any time soon.

Let me be explicit here: I do not mean to assert that the current solvency and regulatory environment *encouraged* banks and other regulated financial services firms to hold large amounts of sovereign debt – which I realise is a hotly contested issue. Rather, my impression is that they do not seem to do much to *discourage* high concentrations.

In summary, *when answering "How much is too much?", it seems to me that we as an industry are given relatively limited regulatory guidance and are pretty much on our own.*

3. Prudent firms need to rely on enlightened self-interest

This leads me to my third observation: that, in answering the question "How much is too much?", prudent firms have to learn from the past and implement sound risk management practices as a matter of enlightened self-interest. And what are the lessons learned by prudent firms? I have three, the first two of which are technical and predictable and the third based more common sense.

First, in terms of our Pillar I internal models, *sovereign issuers should be treated in exactly the same way as corporate issuers* in terms of capital and concentration charges, albeit reflecting their appropriately estimated default probabilities. In this, Allianz group is more prudent than regulatory requirements, having historically included spread risk for most sovereign issuers in our internal model as well as default risk for lower rated sovereigns and those not held domestically in the domestic currency. This more prudent practice is currently under review and I anticipate a strengthening of the principle before the end of the year.

Second, *an informed and objective credit assessment of sovereign issuers should be undertaken*. While intellectually challenging (and likely the theme of a small cottage industry of PhD dissertations in the future), recent experience has demonstrated that this is absolutely necessary. Allianz currently uses an approach for determining internal credit ratings, and associated default probabilities for sovereign issuers which blends three information sources and analysis:

- publicly available ratings;
- our own internal analysis of economic fundamentals such as relative debt levels to tax capacity and GDP etc; and
- market information in the form of bond and CDS spreads.

Stopping here would be the typical response by a technically oriented firm relying on internal models to provide guidance – the models are challenged by actual developments leading the quants to change in the background ("Let's improve the model! Let's improve the model!"), more often than not by making things even more complicated. If I wanted to be cynical, I would say that the some in the financial services industry are so dazzled by their technical cleverness that they risk losing sight of reality.

And what is the reality in my opinion? The reality is that such model enhancements are not a replacement for common sense. In this case, the specific reason is that they are typically adequate over a short time horizon, but not over the time horizon that is relevant for a long-term, liability-based investor.

Let me explain: A previous speaker mentioned that ratings and market data are "informative" with respect to future changes in rating or value, but informative only over the next three- to six-month horizon. While that may sound like an eternity to a may fly (or a bank that can trade in and out of its position daily), as a long-term, liability-based investor having to accumulate very large positions in a hold-to-maturity strategy in order to match our liabilities, three to six months is nothing. As a consequence, while intellectually stimulating, all of the modelling improvements unfortunately may not prove very useful if a sustained bull economy is followed quickly by a bear, leaving us with limited or no ability to replace risky long-term assets with new, lower-risk assets of similar duration in its wake. Such dynamic management is limited by the size of the positions and the availability of new, replacement assets. In this, insurers unfortunately do have a longer-term horizon.

So where does the common sense come in? In this, I am an old-fashioned risk manager living by old-fashioned credos: whenever modelled risk and gross notional exposure get so far apart that you can drive a bus through the difference, be very, very careful! In such situations, only absolute exposure and concentration limits, as opposed to probabilistic, model-driven limits, will prevent you from suffering a material loss when your assumptions fail, as they are sure to do in unexpected ways during the next financial crisis.

This is a lesson that property and casualty companies know very well, for example in the context of natural catastrophe risks where "low frequency" events can blow through modelled MPL (maximum potential loss) thresholds unless total nominal exposures are contractually limited. It may also have been learned in the banking industry, reinforced by the actual experience of such "zero-deemed risk" or low modelled risk positions as monoline guaranteed and derivative-protected positions, CDO warehouses held in the trading book, off-balance sheet SIVs and so on.

So what is the third lesson that prudent long-term, liability-based insurance investors should learn from recent experience? Regardless what our modelled risk numbers tell us, we cannot let our exposure get so big that it threatens our existence when the model assumptions fail, no matter how unlikely the scenario might seem.

4. What are the public policy lessons?

This leads me to my fourth and final observation. Clearly, central banks, public policy and financial services regulation have an interest and a role to play in providing a stable market, financial services sector and real economy. What recommendations would I make, unbidden, to them?

First, when things settle down, *change and strengthen the regulatory framework* – Pillars I & II as well as large exposure rules – so that they do, in fact, encourage good risk management practices. While this understandably may not be feasible today, it is going to make my job as CRO a lot easier in the future: while enlightened self-interest is pervasive in firms with a strong risk culture, it is nonetheless more challenging if all of your less enlightened competitors are perceived as having an easier job of it!

Second, *encourage robust, broad and deep European debt capital markets*. As a European insurer, we need duration and yield if we are to support long-term businesses. But we also need effective diversification. We cannot get this based on sovereign and correlated bank issuers comprising a large part of the European fixed income market. My personal preference would be to take down more public and private debt issued by corporations that are financing productive growth; taking these risks through an opaque and leveraged bank balance sheet is not as desirable. This does not mean that I would like to build a parallel bank business system, creating my own "shadow bank" – nothing could be farther from my wishes! Rather, I would like to see a broad, robust and deep corporate debt capital market develop in Europe, similar to the one in the United States, including both public and private placements to offer institutional investors more direct access and opportunities to finance real economic growth. But this would require changes – for example, consistent documentation across Europe, consistent insolvency proceedings etc – changes that I believe should be encouraged by regulators as well.

Finally, *work towards removing the spectre of risk from sovereign bonds*. Answering the question, "How much is too much?" is not a binary decision. Clearly, our internal assessment of sovereign risk will play a role. If we want to increase the appetite of long-term, liability-based institutional investors, then give us the confidence that the underlying issues are being resolved.

While this is not directly the responsibility of banking and insurance regulators and supervisors, I believe that it would be good if we all collectively reinforced the message that *the underlying fundamentals driving sovereign issuer risk need to be credibly addressed*. Cynically speaking, the past two years have been episodic, with periodic losses in market confidence being addressed by short-term actions such as liquidity infusions and bold statements designed to buy time until the stronger tailwinds of economic recovery or higher debt-financed consumption (again!) can resolve the situation, all while avoiding significant and difficult political decisions regarding the underlying issues. While this is not an entirely fair statement for all countries, the upcoming budget debate in the United States illustrates that there are still a lot of difficult decisions to be made. In the end, only a credible resolution of the underlying issues will restore the confidence of long-term investors.

In summary

This concludes my four observations, which were, in summary:

- There are compelling reasons to change the traditional business model for long-term, liability-based investors – we simply cannot afford the historically high concentrations to sovereign issuers as in the past.
- The relevant question is therefore, "How much is too much?", and I do not think that we can rely on the regulatory framework to guide us in answering this question.

- Rather, firms need to base their decisions on enlightened self-interest, focusing especially on:
  - improving internal capital models to treat sovereigns like corporate issuers;
  - improving our internal credit assessment of sovereign issuers; and
  - most importantly, in case our great modelling relies on assumptions that turn out to be wrong in the next crisis, not allowing very high concentrations, even (or especially) when the modelled risk is a small fraction of the notional exposure.
- But enlightened self-interest is not enough. Regulators and public policy setters should consider:
  - when the situation improves, better aligning the regulatory and solvency framework with "enlightened self-interest";
  - encouraging the development of a broad, deep and robust corporate debt capital market in Europe; and
  - finally, urging that the underlying fundamentals are addressed, potentially requiring difficult political decisions.