

Insurance Europe

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The challenge of change: global insurance trends

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Keynote speech

- Thank you for inviting me here today. It is a welcome opportunity to speak about the FSB's agenda for global financial reforms, and how the regulation of insurance has come to be a part of our objective to create a resilient global financial system that supports strong and sustainable long term economic growth.
- In the aftermath of this crisis, it was clear to politicians, authorities, financial industry participants and citizens alike that deep-seated financial reforms were needed to address the major faultlines that caused these events. Much of that reform has focused on banks, on OTC derivatives markets, securitisation and shadow banking. But a major objective has also been to address the problem of TBTF, which will be the focus of my remarks.
- TBTF is a phenomenon of long standing and used to be thought of as a banking problem. But this crisis put paid to that. Broker dealers, MMFs, a few very large insurers, and large swathes of the securities markets also needed public solvency and liquidity support during the crisis. And the costs to the public purse were large. As a result, in 2009, political authorities directed financial regulators to identify and to address, with appropriate policy measures, any financial institution or activity whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.

- The FSB was asked to develop a framework for ending TBTF and since 2010, good progress has been made in putting this into place. The framework involves identification of globally systemic entities, and the development and application of associated policy measures. These policy measures pursue the same objectives whether the entity is a bank, an insurance company, or a critical financial market infrastructure: they are designed to place greater protections in the system where the impact of disorderly failure could put the wider system at risk. The main channels through which this is achieved is (i) loss absorbency requirements that are proportional to the firm's systemic impact on default, (ii) resolvability requirements that ensure that failing systemic entities can be resolved in an orderly manner without reliance on public funds, and (iii) more effective and coordinated supervision of globally systemic entities.
- It is well recognized by financial authorities that well managed traditional insurance - a liability driven, long investment horizon business generally uncorrelated with the business or financial cycle - is a fundamental source of resilience for the financial system and economic activity. But insurance groups also engage in non-traditional or non-insurance activities, sometimes in significant volume. Even where these do not reach the scale of AIG before the crisis, they can have adverse implications for insurer solvency and liquidity and for their counterparties in the financial system. The crisis also showed how particular insurance markets may in aggregate affect systemic stability. As we saw with the monoliners, insurance markets can amplify shocks when a sector or sub-sector is excessively concentrated or undercapitalised.
- In many cases, these non-traditional non-insurance activities have not been adequately covered by insurance prudential frameworks. They also posed challenges of capture from an accounting perspective. As a result, the associated risks were not adequately disclosed to the public nor to insurance supervisors with an interest in the group.

- To identify globally systemic insurers - or G-SIIs – an assessment methodology was developed by insurance supervisors in the IAIS. The methodology - which was informed by substantive interactions with the insurance industry - was subsequently endorsed by the FSB. It focuses predominantly on types of non-traditional, non-insurance activities¹, as well as other sources of interconnections of major insurers with the rest of the financial system. It is not a piece of mathematical science; instead, its application requires careful judgment of senior regulators and supervisors.
- As with the methodology, the development of policy measures that will apply to G-SIIs have also relied on insurance supervisory expertise, ensuring that the policy measures are tailored to the specificities of the insurance business model. The Basic Capital Requirement now under development as a basis for computing higher loss absorbency recognizes these specificities. It will not discourage traditional insurance activities. But it will serve to dis-incentivise large insurance groups from developing in scale non-traditional activities that have demonstrated inherent vulnerabilities and that are the considered target of regulatory measures in other sectors.
- The policy response is also designed to support more consistent supervisory oversight of global insurance groups. Yours is a globalising industry, and robust minimum international prudential standards are needed for the internationally active part of the insurance sector. The IAIS's work to develop a sound capital and supervisory framework for internationally active insurance companies is therefore strongly supported by the FSB.

¹ In short, “non-traditional” activities are those whereby the promises made by an insurer can be met only through extensive use of market instruments, such as derivatives. For variable annuities, for example, insurers rely on large scale hedging programs to ensure guarantees to policy holders. Non-traditional non insurance business can also include products with credit related exposures, e.g. CDS, securities lending or other activities which involve maturity transformation.

- Let me add a few word on the FSB work on resolution. G20 jurisdictions have agreed to ensure that any domestically incorporated financial institution that could be systemically significant or critical if it fails is subject to a resolution regime that complies with the FSB Key Attributes of Effective Resolution Regimes. The Key Attributes is a high-level standard that covers a range of financial firms, including banks, insurers and financial market infrastructure. For insurers, this means that resolution regimes should cover not only designated G-SIIs, but any insurer that could have a systemic impact in the event of failure.
- I have heard it said that the Key Attributes were designed primarily for banks. That is not true. Indeed, they contain insurance-specific provisions on run-off and portfolio transfer – the tools that are traditionally most commonly used to manage the failure of an insurer.
- We recognise that sector-specific guidance is needed on the implementation of the high-level standards to different sectors, including insurers. For that the reason, last summer the FSB published a consultation package of implementation guidance on the application of the Key Attributes to non-bank financial institutions. The draft Annex recognises insurance sectoral specificities: for example, the nature of insurers' liabilities, their lower susceptibility to runs as compared with banks. However, while the conventional tools of portfolio transfer and run-off will be suitable for dealing with many – possibly most insurance failures – the FSB does not believe it will be possible to rely on these tools in all circumstances. In particular, it is hard to be convinced that run-offs or portfolio transfers will be adequate to contain the systemic impact of failing insurance groups with large derivatives books, securities financing operations or other activities that involve significant leverage and maturity transformation.
- The guidance is now being finalised in the light of responses to that consultation and will be published as a new Annex to the Key Attributes

before the G20 summit in November. The FSB and the IAIS are also considering whether supplementary guidance should be developed on specific aspects of resolution planning for insurers.

- The G20 and the FSB have committed to substantially complete by the Brisbane summit the main outstanding elements that are needed to resolve globally systemic firms. This includes, most importantly, a proposal for G-SIBs to have enough going concern loss absorbing capacity, i.e. to ensure that enough resources are available to absorb losses and sustain their critical economic functions in resolution. As this comes on stream, the insurance sector's exposure to the banking system will change. It will be a fact of life that holder of bank debt should have no expectation of tax payer bail-out sparing their losses. And we are working intensely to deliver a framework for the cross-border recognition of resolution actions, a critical element in achieving orderly resolution of globally operating groups. What is learnt there will likely also have implications for insurance firms.
- In closing, I would like to leave you with three messages. First, post crisis, there is a different level of alertness to the fact that systemic risk can originate from many places and take different shapes. Second, the policy response to systemic risk is to place greater protection where the systemic footprint is greatest, and ensuring that systemic entities and activities can be resolved without discontinuity of critical economic functions. Third, the policy response is targeted to sectoral characteristics. For this reason, the global regulatory community is heavily reliant on the expertise of insurance regulators and supervisors, as well as firms. Indeed, the FSB could not have delivered on its mandated tasks without strong, independent international standard setters, capable of the expert judgment that is needed to successfully complete this work.

Last, as we emerge with more certainty from the global financial crisis, the focus of the FSB will be moving increasingly to implementation and assessment of whether reforms are having their intended results. One of the

lessons of this crisis is that we need a regulatory approach that is regularly reviewed and adjusted to take account of evolving financial conditions, product innovation and changing market conditions, and that is ready to amend regulation where these have material unintended consequences. In developing and maintaining a system of robust, internationally consistent regulation and in ensuring it meets its goals, robust interaction with the industry is also essential. We all have an interest in working together in ensuring that the insurance sector remains resilient and through it, the wider global financial system.