Financial Stability Board consultations on Strengthening Oversight and Regulation of Shadow Banking, 18 November 2012

The ABI's Response.

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Introduction

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

ABI responses to Financial Stability Board consultations on Strengthening Oversight and Regulation of Shadow Banking

We provide comments below on three FSB consultations on shadow banking:

1. An Integrated Overview of Policy Recommendations
2. A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities
3. A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

The ABI appreciates the opportunity to comment on these important contributions to the ongoing debate on how to identify and reduce risks to the stability of the financial system.

ABI response to "Integrated overview of policy recommendations" consultation

The ABI supports the FSB's intention to identify risks posed to the financial system by leverage and maturity transformation undertaken by financial institutions outside of the banking system, in particular where those activities are vulnerable to bank-like runs or contagion risks.

However we believe that the FSB should recognise the benefits to the economy of non-bank credit intermediation at a time when banks are deleveraging. The FSB should also acknowledge that non-bank credit intermediation is not of itself problematic in regulatory terms, and does not necessarily have the potential to pose systemic risks. We note in particular that where non-bank credit intermediation does not involve any maturity transformation or leverage (for example direct investment in long term credit by insurers and pension funds where those investments are matched appropriately with long term liabilities held by the institution), it has the potential to contribute to rather than undermine financial stability.

When proposing policy measures to combat the risks to financial stability posed by credit intermediation conducted by bodies outside the regulatory regime for banks, the first focus should be on unregulated entities. If institutions that are already subject to sectoral regulation are undertaking credit intermediation that does involve maturity transformation or leverage, then FSB should build – where possible – on the regulatory regime that these bodies are already subject to. In some leading jurisdictions, remedies or mitigants already exist for many of the legitimate concerns about financial stability raised by the FSB.

We are concerned that policymakers' default approach may be to apply remedies and mitigants appropriate to banking. Of course the measures proposed need to address the banking style risks, and potential for regulatory arbitrage, but this does not necessarily mean that banking style measures are necessarily the most effective response in every situation. Many of these bodies are based in the securities and insurance markets, and subject to different incentives and pressure from banks.

Measures built into their existing regulatory regime are more likely to be effective, and to avoid the costs and confusion of duplicatory or contradictory regulation.

Before taking action, the FSB should also draw up a balance between the role of the proposed policy measures in reducing the risk of financial stability, and their impact on the economic benefit currently generated by these activities. For example, insurance makes a major contribution to financial stability, and measures that reduce the take-up of insurance, or add to its cost, will necessarily reduce financial stability. Similar arguments can be advanced based on the economic role of the securities markets. The very high cost of the financial crisis has led policymakers to impose measures in the name of financial stability without properly weighing the impact. This was understandable in the immediate aftermath of the crisis, but is not a sustainable way to proceed in the medium term, and the basic disciplines of cost-benefit analysis need to be restored.

The five general principles set out for regulatory measures (that they should be focussed, proportionate, forward looking and adaptable, effective, and subject to regular assessment and review) are sensible and we fully support this approach. Unfortunately, not all the regulatory measures so far proposed meet these principles.

We suggest that the assessment and review stage should be applicable not only to the shadow banking regulatory measures, but to all of the sectoral workstreams initiated by the FSB on systemic risk. The reviews should examine the extent to which the various assessments and measures are duplicated in or made redundant by those in other workstreams (for example, any general measures that mitigate the potential for securities lending activities to pose a systemic risk should lead to a reassessment of the relevant indicators in the IAIS' methodology for identifying systemically important insurers).

It is important that any additional regulatory measures should be proportionate to the risks they seek to mitigate. In the case of variable NAV MMFs we see no need for any banking-style regulatory overlay to be applied in addition to the oversight that is already applied as appropriate for any investment fund.

On the securitisation workstream, we support improved disclosure in general and also the introduction of minimum risk retention requirements for credit securitisation products - providing that they are set using appropriate methods (principles not formulae), and at an appropriate level.

We appreciate Footnote 13 regarding the need for further work on definitions for securitisation, and emphasise its importance when considering securitisation of insurance risk, which differs substantially from credit securitisation, given that:

- Insurance Linked Security (ILS) vehicles do not perform maturity transformation

- ILS vehicles provide sufficient disclosure/transparency to investors and supervisors to fulfil the requirements of the FSB toolkit.

We therefore emphasise that measures applied to credit securitisation products should not necessarily be considered suitable for other securitisation products, such as ILS.

A number of proposals are made in relation to credit insurance and the provision of financial guarantees. The scope of the definition of credit insurance is unclear, but from the examples given it does not appear to be intended to apply to, for instance, payment protection insurance or mortality/critical illness cover for mortgagees. It would be helpful if the scope of the proposed tools relating to the "facilitation of credit creation" could be clarified in this respect.

We provide some comments on the securities lending and repo workstream, and to proposed tools relating to credit insurance and financial guarantees in our response to the individual consultation papers , which follows below.

ABI response to "Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities"

Our comments on this policy framework relate to the proposed tools for credit insurance and financial guarantee providers. A separate response to the Securities lending and repo consultation is included below. Views on elements of the other workstreams relating to insurance are set out in our response above to the integrated policy overview.

Tool 1: **Minimum Capital Requirements**

Appropriate capital requirements are a central element of insurance prudential regulation in Europe, and we believe that existing and forthcoming European regulatory capital provisions for credit insurance and financial guarantee business will provide this.

Tool 2: Restrictions on scale and scope of business

We agree that the ability to appropriately price and manage risks should be considered a fundamental pre-requisite for any institution providing financial guarantee or credit insurance products. However this recommendation does not give any information on how authorities would establish whether or not an institution possesses that ability. Any such assessment should focus on technical competence, resource and processes within the institution. Authorities should not attempt to set boundaries for (or otherwise quantitatively restrict) risk-prices. Authorities should not set exposure limits on new asset classes or market sectors merely because they are "new" – any limits should be either hard limits applied across all assets and sectors, or else should be linked directly to the potential for the asset class or sector to be a source or transmitter of systemic risk.

Tool 3: Liquidity buffers

It is crucial to first recognise that credit insurers and financial guarantee providers are not themselves funded by short-term financial instruments, nor (as the consultation acknowledges) are the products that they provide themselves tools for maturity transformation. It is therefore unclear what circumstances the FSB believe would prompt a creditor run on such institutions – and, given their funding profile, it is difficult to see in what way this would be a significant financial instability consideration.

Nevertheless, management of liquidity risk is a core component of operations for all credit insurance and financial guarantee providers and relevant regulators supervising credit insurance and financial guarantee business should perform a robust assessment of the adequacy of liquidity throughout the business cycle.

Tool 4: Enhanced risk management practices to capture tail events

We support the FSB recommendations for loss modelling and periodic stress testing which are both central elements of the incoming Solvency II regime. Regulators should ensure that credit insurers and financial guarantors undertake such analysis.

Tool 5: Mandatory risk sharing

Some members have expressed uncertainty over whether in this section the “insured” refers to the borrower (or issuer) of a guaranteed debt or to the lender (investor) in that debt. Our response assumes that it is intended to refer to the latter, however we would appreciate greater clarity on this matter.

In the first place we wish to emphasise that the most direct and efficient means by which the risk of imperfect credit risk transfer could be reduced would be to ensure that the issuer of the security provides investors, whether insured or not, with comprehensive disclosure on the underlying debt being issued.

Furthermore we consider that it is essential that consistent and appropriate rules and regulations are applied for both banks and shadow bank entities when undertaking broadly equivalent activities to prevent distortions and arbitrage opportunities. One primary example would be where credit enhancement is provided by a letter of credit from a bank, rather than in the form of credit insurance or a financial guarantee.

In practice it should also be noted that there are many circumstances in which investors may be prevented from retaining a portion of the underlying credit risk – for example, if they are prevented from holding or investing in securities below a certain rating and the unguaranteed portion of the investment would not achieve that rating. Introducing this requirement could therefore have far reaching consequences both for the scope of investment of many institutions, and for the ability of businesses and governments to raise finances. These should be explored thoroughly and the impacts considered before proceeding with this tool.

Finally, it is unclear why it is supposed that information must be shared between the insurer/guarantor and the insured/guaranteed party to give effect to this tool, since the ultimate source of any information on the underlying must be neither the insurer nor the insured, but the issuer of the insured/guaranteed security. It would therefore appear that any useful information sharing requirement would certainly have to include the issuer.

<u>ABI response to "Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos"</u>

ABI members are active participants in both the securities lending and repo markets, and we believe that there are important factors that must be taken into consideration in relation to policy recommendations set out in this consultation. Our comments are set out below in relation to the three broad groups of recommendations, and to the proposal that authorities should undertake a cost benefit analysis of whether to introduce CCPs in their stock-lending and repo markets.

Recommendations 1-5 : Improved data collection, reporting and transparency.

We broadly support improvements in data collection, reporting and transparency although care should be taken to ensure that the costs imposed are not too great. Also any additional data collection and reporting proposals should be assessed to ensure that they are provide meaningful and usable information. It is important, for example, to understand the purpose of stock lending and repo transactions to ensure data is interpreted in the correct way

While we support the principle of increasing market transparency, care is needed to ensure that a harmonised global approach is adopted to:

- Provide clarity over where activity should be reported where multiple locations are involved to avoid duplication;
- Prevent inconsistencies in requirements between jurisdictions; and
- Ensure that the depth of data required is sufficient to meet supervisory objectives, but not so excessive that its analysis detracts supervisory resource from the key matters that supervisors should focus their attention on

Recommendations 6 and 7 : Minimum standards / numerical floors for collateral haircuts

We fully recognise that understanding market conditions in stock lending and repo can be essential to understanding the overall market in credit formation and leverage in the financial system. This is, accordingly, a proper area of interest and activity for central banks and other bodies responsible for safeguarding financial stability. It does not follow, however, that remedies to promote or discourage credit formation are necessarily best applied in the stock lending and repo markets themselves.

The imposition of statutory minimum haircuts would introduce new potential risks to the financial system. If they are set at too high a level they pose a systemic risk to market liquidity. If they are set too low then there is a potential moral hazard risk that participants may abdicate their responsibility to conduct their own risk analysis and simply gravitate to the regulatory minimum haircut as a market standard. There is also a danger that where ‘haircuts’ are not calibrated to firm’s individual risk appetites then could lead to pro-cyclical effects.

Indeed, we are concerned that these proposals are being made with little analysis of the potential impacts, including the possibility that these requirements could be costly to introduce and enforce while ultimately creating risks that could equal or exceed those that they are intended to address. We note also that stock lending and repo markets provide an important liquidity and price discovery mechanism for the financial markets and the imposition of statutory haircuts may have the negative impact of discouraging market participants.

Recommendations 8-11: Collateral management (in particular rehypothecation of cash collateral)

We agree with the spirit of the high level principles, but do not favour prescription in the manner that they should be applied. Rather, we are strongly of the view that individual investors should be able to determine their own investment guidelines consistent with the principles and their individual risk appetite. We also believe that investors should be able to demonstrate to their supervisor their rationale for the appropriateness of the individual guidelines adopted.

Recommendation 12 : Authorities should conduct a cost benefit analysis of whether to introduce CCPs in their security lending and repo markets.

We agree with the paper’s broad scepticism over the need to encourage central clearing for stock lending and repo. We do not think central clearing offers any obvious benefits to market users or in combatting systemic risk. We consider that the legitimate interest of regulatory authorities in accessing information about these markets can be best achieved through the trade repository route.