Systemically important financial institutions

Transatlantic Insurance Groups Conference

Frankfurt, 7 - 8 September 2011

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Where the SIFI discussion began…

- Failure of large and highly interconnected institutions had significant impact on the global financial system and real economy
- Financial crisis raised moral hazard concerns - „too big to fail“, „too complex to fail“ or „too interconnected to fail“
- Critical views of government bail-out solutions (use of taxpayers’ money);
- Comprehensive rescue packages are becoming more difficult (also due to level of countries‘ indebtedness)
- Negative externalities were not considered by SIFIs

FSB/ IMF/ BIS definition of systemic event

“Systemic event is the disruption to the flow of financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.”

This means:

- A systemic event must fulfill both criteria (impairment of financial system and possible serious spill-over to the real economy)
- Events with potential to have serious negative impact on real economy – without major consequences for the financial system – are not systemic events
- Disruptions in the financial system without significant macroeconomic consequences or „only“ wealth effects are not systemic events

Systemic risk and SIFIs

- Systemic risks can be generated through financial institutions, markets or instruments.
- In a first phase, the focus has been on systemically important financial institutions (SIFIs).
- SIFIs are *„…those institutions whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity."*

Some relevant reports and statements

- **October 2009**: FSB/IMF/BIS Report to G20 on *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments*
- **October 2009**: IAIS Position Statement: *Systemic Risk and the Insurance Sector*
- **October 2010**: FSB Report: *Reducing the moral hazard posed by systemically important financial institutions – FSB Recommendations and Time Lines*
- **November 2010:** *FSB Report: Intensity and Effectiveness of SIFI Supervision – Recommendations for enhanced supervision*
- **July 2011**: BCBS Consultative Document: *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*
- **July 2011**: FSB Consultative Document: *Effective Resolution of Systemically Important Financial Institutions – Recommendations and Timelines*

BCBS assessment methodology

… an **indicator-based** measurement approach with the following categories:

1. **Size**
2. **Interconnectedness**
3. **Substitutability**
4. **Cross-jurisdictional activity**
5. **Complexity**

- Each category weigthed: 20%
- Indicators equally weighted within a category

Additional loss absorbency for G-SIBs

Bucket approach for additional loss absorbency:

Bucket	Score range*	Minimum additional loss absorbency (common equity as a percentage of risk-weighted assets)
5 (empty)	D -	3.5%
4	C - D	2.5%
3	B - C	2.0%
2	A - B	1.5%
1	Cut-off point - A	1.0%

Application of the BCBS methodology

- Incentive to change bank’s risk profile and business model
- Periodic review of SIFI status of banks
- Banks can migrate in and out of G-SIB status and between categories
- Structural changes will be captured through annual supervisory judgement process
- Full sample of banks will be reviewed every three to five years
- Cut-off score and treshold scores for buckets will be fixed for three to five years

Stability issues and IAIS objectives

The objectives of the IAIS are to

- promote effective and globally consistent supervision of the insurance industry
- in order to develop and maintain fair, safe and ***stable insurance markets*** for the benefit and protection of policyholders, and to
- ***contribute to global financial stability***

IAIS position on systemic risk (1/3)

- Difference between the (traditional) insurance business model and the banking business model needs to be considered when assessing systemic importance of insurance
- Time dimension (besides size, interconnectedness and lack of substitutability) is important in insurance (both in respect of business model and regulatory action)
- Little evidence of (traditional) insurance either generating or amplifying systemic risk

IAIS position on systemic risk (2/3)

- Insurance sector is susceptible to systemic risk generated in other parts of the financial sector
- Insurers may amplify risk under specific circumstances e.g. through reacting to downturns in capital markets or through unexpected withdrawal of capacity
- Non-traditional insurance and non-insurance activities within insurance firms or groups may generate or amplify systemic risk

IAIS position on systemic risk (3/3)

- Regulatory and supervisory enhancements necessary to minimise adverse externalities, including stronger risk management and enhanced resolvability
- Effective group-wide supervision is key (extending to non-traditional, non-insurance, non-regulated activities/ entities and non-operating holding companies)

(Draft) IAIS methodology to assess systemic importance of insurers

… an **indicator-based** measurement approach with the following categories:

1. **Size**
2. **Global activity**
3. **Interconnectedness**
4. **Substitutability**
5. **Non-traditional business**

Relevant features of “traditional insurance”

- Insurable interest and insurability
- Underwriting of large diversified pools of mostly ideosyncratic and uncorrelated risks
- Inverted production cycle: premiums paid upfront by policyholders
- Investments are funded by premium income and held to match liabilities
- Payments to policyholders require – in general – the occurrence of an insured event
- Disincentives to cash-in policies prematurely (Surrender penalties)

Measures applicable to all SIFIs

- Resolution framework … to ensure that all financial institutions can be resolved safely, quickly and without destabilising the financial system
- SIFIs must have higher loss absorbency capacity
- More intensive supervisory oversight for SIFIs
- Robust core financial market infrastructures to reduce contagion risk from the failure of individual institutions
- Other supplementary prudential and other requirements as determined by the national authorities

Measures applicable to G-SIFIs

- Enable a rigorous coordinated assessment of the risks facing the G-SIFIs through international supervisory colleges
- Make international recovery and resolution planning mandatory for G-SIFIs and negotiate institution-specific crisis cooperation agreements within cross-border crisis management groups (CMGs)
- Subject their G-SIFI policy measures to review by the proposed Peer Review Council

Challenges of the IAIS G-SIFI project

- Definition and scope of non-traditional and non-insurance business
- Complexity of indicators
- Data definition and availability
- Confidentiality of data
- Role of size in insurance
- Parallel national processes of SIFI identification
- Intensive discussion on measures for SIIs
- Calibration of SIIs against SIBs

Some conclusions on systemic risk and insurance

- Traditional insurance business unlikely to be a source of systemic risk
- Deviations from traditional insurance business model could create a potential for systemic risk
- Regulatory arbitrage through shifting systemically relevant activities from banking to insurance must be avoided
- Insurance groups should not be incentivised to move into non-traditional and non-insurance activities
- In case of a systemically relevant insurer the supervisory authority needs to have all necessary tools available

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