Interconnectedness between Banking and Insurance

Frankfurt, September 5, 2013
Global Insurance Supervision:

- Not possible without taking interconnectedness in the financial area into account
- Interconnectedness an important issue in the discussion on systemic risk

Long-term goal: not only Global Insurance Supervision,

but Global Financial Services Supervision
Interconnectedness between Banking and Insurance

Agenda

1. Introduction
2. Regulatory Issues
   • Basel Accords vs. Insurance Regulation
   • Bail-in Debt
3. Research
Introduction
Can insurance companies be systemically important?

The Basel Committee’s assessment methodology identifies five categories to measure banks’ systemic importance:

- Complexity: 20%
- Cross-jurisdictional activities: 20%
- Interconnectedness: 20%
- Substitutability: 20%
- Size: 20%

The IAIS’ assessment methodology identifies five categories to measure insurers’ relative systemic importance:

- Global activity: 5%
- Interconnectedness: 40%
- Non-traditional insurance and non-insurance activities: 45%
- Substitutability: 5%
- Size: 5%

The potential for systemic risk in insurance may become relevant when insurers significantly deviate from the traditional insurance business model and/or become highly interconnected with the banking industry.
Interconnectedness dimensions: Bonds and equity capital

Europe

In 2011, insurers held around 12% of all banking-sector liabilities to non-banks\(^1\)

Germany

Estimated proportion of insurers’ assets invested in bank bonds, bank loans and bank deposits is between 39% and 43%\(^2\)

Bank bonds represent an important part of insurers’ asset portfolios

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\(^1\) Deutsche Bank Research (2011)
\(^2\) Kaserer (2011)
Bank bonds in life insurance portfolios

On the one hand: **natural connection**

- Long duration of life insurers’ liabilities
- Long duration of bank loans
- Present duration mismatch in both sectors can be mitigated by issuing and holding long duration bank bonds

On the other hand: **contagion risk**

- The default of bank bonds held by insurers leads to a decline in insurers’ asset values
- Additional danger if bank bond defaults originate in events that also directly affect insurers.
  E.g.: The default of sovereign debt held by insurers (on average 28% in 2011) affects insurers’ balance sheets directly and indirectly via bank bonds
- Financial conglomerate: **Reputational risk** due to financial distress in the other sector
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Regulatory approaches for banking and insurance: Interconnectedness between banking and insurance not taken into account

Example: Basel Accords and Solvency II

**Basel II / III**
- Requires banks to establish more stable, long-term sources of funding
- Financing Instruments will only be recognized as Tier 1 and Tier 2 if they include *loss-absorbing components*.

**Solvency II**
- Motivates insurers to close the duration gap (via interest rate risk module)
- However, capital requirements for corporate/bank bonds become more stringent as maturity periods increase and *credit ratings deteriorate* (spread risk module constraint)

Interdependencies and overall effects on, e.g., loan supply?
Bail-in Debt

Liikanen proposal

• Resurrecting market discipline in banking via funding:

  **Mandatory** issuance of bail-in debt

  • In financial distress, these bonds can be converted into equity (CoCo bonds)
  • They must be priced accordingly (high coupon compensates for high expected loss)
  • Bondholders must be non-banks
Bail-in Debt

Liikanen proposal

- Bail-in debt as complement not substitute to more equity capital

- Risk is shifted to whom?
  - Life insurance companies
  - Pension funds
  - Hedge funds
Bail-in debt – an ideal investment for life insurers?

• Are life insurers natural holders of CoCo-Bank Bonds?
  • Life insurers less exposed to short-time customer reactions than banks (bank run versus insurance run)
  • Compensation of insurers via high spread that must be accumulated in a “catastrophe reserve”
  • Thus, after e.g. 15 years, a complete default could be financed via the additional spread

• Assessment
  • Life insurers’ task is to provide safety for their policyholders, not for banks
  • How do policyholders participate?
  • However, if the terms are appropriate, why not invest in bail-in-bonds?
  • Especially relevant in the present low-interest rate phase
  • Effects must be thoroughly studied
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Recent research on systemic risk and interconnectedness in banking and insurance


Findings:

• Banks create significant systemic risk for insurers but not vice versa
• Insurers seem to be the victims of systemic risk rather than instigators
Recent research on systemic risk and interconnectedness in banking and insurance


Findings:
- Significant downside-risk dependence between banking and insurance sectors
- They conclude that the probability of a crash is lower if European banks diversify across other sectors (→ bail-in debt)
“Optimal Risk Policies for Interconnected Banks and Insurers in the Presence of Solvency Regulation“

• Regulatory effects on the interconnectedness of banking and insurance

• Shareholder value perspective of both banks and insurers

• “Drivers” of the model: customer reactions
  • Depositors on the banking side
  • Policyholders on the insurance side
“Optimal Risk Policies for Interconnected Banks and Insurers in the Presence of Solvency Regulation“

- Effect of Basel II / III and Solvency II on asset allocation in both sectors and interconnectedness via bank bonds
“Optimal Risk Policies for Interconnected Banks and Insurers in the Presence of Solvency Regulation“

• First findings and outlook
  • Customer sensitivity to default risk as well as regulatory rules that influence interconnectedness are crucial for overall riskiness
  • Industry-specific regulatory safety levels and risk measurement lead – in their interplay – to different levels of contagion risk between banks and insurers
  • Identify combinations of regulatory safety targets leading to beneficial or detrimental outcomes (for customers and / or owners)
Backup
## Liste der system relevanten Banken

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<thead>
<tr>
<th>Deutsche Bank</th>
<th>Bank of China</th>
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<tr>
<td>HSBC</td>
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<td>JP Morgan Chase</td>
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<td>UBS</td>
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The reciprocal effects have to be considered. Default of sovereign debt held by insurers affects insurers’ balance sheet directly and indirectly via bank bonds.
Global Systemically Important Institutes

28 G-SIBs:
- Citigroup
- Deutsche Bank
- HSBC
- Santander
- JPMorgan Chase
- Bank of America
- BNP Paribas
- Bank of China
- Société Générale
- UBS
- Unicredit Group
- Sumitomo Mitsui FG
- ING Bank
- Barclays
- Credit Suisse
- Wells Fargo
- Goldman Sachs
- Mitsubishi UFJ FG
- Royal Bank of Scotland
- Standard Chartered
- BBVA
- Morgan Stanley
- Groupe BPCE
- Group Crédit Agricole

9 G-SIs:
- Allianz SE
- American International Group, Inc.
- Assicurazioni Generali S.p.A.
- Aviva plc
- Axa S.A.
- MetLife, Inc.
- Ping An Insurance (Group) Company of China, Ltd.
- Prudential Financial, Inc.
- Prudential plc
Global Systemically Important Institutes (G-SII)

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