The impact of the financial regulatory reform over Insurance & Pensions

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Section 1

Introduction

- The Insurance and Pension industries will face a cross roads as a result of the combination of **regulatory pressure and persistently low interest rates** in a context of aging population is a number of Developed Economies.
- **This new trade-off** (higher regulatory costs for risky investments vs. the need to increase the yield income) **implies a challenge for these firms: the need to reconcile higher risk sensitivity of capital and more appetite for high yield assets.**
- This situation is complicated by **the indirect impact on P&I of the profound regulatory reform of the banking industry**
- As a consequence, **new opportunities** in terms of investment or partnership **might arise for the Insurance and Pension businesses.**

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Section 2

New regulation affecting the I&P industry: Solvency II

Solvency II was born after the dotcom crisis and was inspired by Basel II. Initially a European initiative but with far reaching impact

Solvency II is based on three pillars:

- Pilar I: Risk-based measurement and management of assets, liabilities and capital
- Pilar II: Qualitative review (requirements for the governance, risk management and effective supervision of insurers)
- Pilar III: Transparency requirements.

Other Issues

- Asset Investment policies driven by the liabilities characteristics.
- Calculation of the available capital as the difference between the market value of assets and the market value of liabilities.
- The excess capital is the difference between the available capital and the Solvency Capital Requirement (SCR).

Section 2

New regulations affecting banks & financial markets

In the banking sector, the current crisis has fostered a plethora of measures

	Increase banks solvency	Mitigate system's complexity/risks	Minimize taxpayers' fiscal burden
Basel III	●	●	
SIFIs	●	●	
Crisis Management		●	●
Structural reforms		●	●
Effective supervision		●	●
Macroprudential		●	●
OTC derivatives	●	●	
Shadow banking		●	
Rating Agencies			●
Financial taxation			●

Section 2

…which are putting a lot of pressure over banks

3 Banks will have to raise new high quality capital and reduce their risks

	Description	Possible effects
Basel III-capital	- Minimum 7% CET1 ratio with stricter definitions - Plus conservation, countercyclical , SIFI buffers - Enhance loss-absorbing capacity - RWA: Higher charges for risky assets/activities	Banks to deleverage. issue more equity; reduce activity in securitization, repo, derivatives trading, prop trading…)
Basel III-liquidity	- Liquid assets must cover net cash outflows under a 30 days stress episode - Weighted long term assets must be 100% funded with long term stable liabilties	Lquidity management becomes cricial. More appetite for domestic and high grade sovereigns & covered bonds Need to match long term A&L
Basel III- leverage	- Tier 1 capital to total assets cannot exceed 3%	Deleveraging, limited capital saving through IRB models
Bail in	• Mandatory bail in (capital, hybrids and even senior debt to absorb losses), RRPs , higher collateal	Reduced appettite for bank debt as it becomes more risky/less atractive
OTC derivatives	• More standardization, higher margin and collateral requirements, Obligation to go through CCPs. Disclosure requirements	More plain vanilla, less tailor made Increases cost of trading wth derivatives
Taxation	• Tax transfers or holdings of deposits, equity, bonds, derivatives	Higher intermediation costs

Section 3

…with key implications over their business strategies

4 Bank deleveraging is direct consequence of these new incentives

Table 1. EU global banks considering a reduction in banking activities and/or assets (out of a sample of 23)

	Number of EU banks	In %
BANKING ACTIVITIES		
• Investment	13	57%
• Corporate	16	70%
• Retail	15	65%
ASSETS		
• Banks subsidiaries/branches	8	35%
• Insurance	5	22%
• Asset management	12	52%
• Securities companies	6	26%
• Shadow banks	11	4%

Source: IMF GFSR, April 2012

Significant retrenchment from investment and corporate banking, but also retail

Significant deleveraging in asset management, non core assets

Insurance and shadow banking less affected

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Overall impact over the insurance and pensions industry

Different effects of S-II in each country, depending on starting conditions

	Pension funds					Insurance companies (life)			
	Total	% portfolio				Total	% portfolio		
Country	% of PIB	Bonds and Bills	Cash and Deposits	Equity	System	% of GDP	Bonds	Loans	Equity
Australia	82,5	12,8	16	54,4	DB/DC	2,3	53,1	3,7	21,9
Austria	5	54,9	9,8	26,8		0,1	17,6	0,3	na
Belgium	4,1	40,8	6,2	34,5		4	81,4	6,9	7,2
Canada	60,3	35,2	3,9	33,9	DB/DC	22,7	38,4	2,6	22,4
France	0,77	na	na	na	DC	16,8	76,3	0,6	20
Germany	5,2	40,8	3,3	6,1	DB	29,5	35	33,3	3,5
Italy	4,1	49	6,4	11,1	DB/DC	6	91,8	na	3,3
Japan	20,6	47,7	6,4	13,7		52,76	54,5	16,34	5,36
Korea	3,6	33,8	40,2	2,7	DB/DC	23,9	40,5	23,7	6,3
Mexico	12,2	80,6	1	14,9	DB/DC	1	84,9	1,5	0,4
Netherlands	129,4	46,5	3,6	32,2		34,8	57,9	11,5	16,8
Spain	8,1	59,2	18,5	12,1	DB/DC	1,62	na	na	na
Sweden	8,2	60,9	2,97	31,4		52,9	55,5	0,6	35,5
Switzerland	100,6	36,5	na	25,7	DB	46,7	55,7	12,6	1,6
UK	66,6	4,2	28,6	39,6		94,7	33,3	1,79	43,8
USA	68	31,4	2,2	45,4	DB/DC	3	79,9	12,9	3,4
average	36,2	42,29	10,65	25,63		24,55	57,05	9,17	13,68

- Differences in the relative weights of the insurance and pension sectors across countries
- The risk profile of the asset portfolio is also rather different.
- Countries with a more developed second pillar pension have higher volumes of savings…
- … and their assets are more concentrated in equities.
- Final effects of SII will depend on the starting solvency level and the asset mix of each entity.

Overall impact over the pensions and insurance industry

New incentives generated under Solvency II+ low interest rate context

Transfer of risks towards reinsurers or through securitization.

Higher demand for derivatives to hedge exposures (IRS, etc)

Increased demand of high rating, long term sovereign debt

Pressure towards less risk

Yield obligations of DB pension plans

Need for assets with a higher risk /return

New investment opportunities in non listed assets, Ex: Infraestructures, real estate

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Overall impact over the insurance industry

New incentives for the insurance industry under Solvency II+ low rates

- QIS 5 (2010) pointed to good capitalization levels …
- … but sovereign debt crisis led to sharp deterioration of BS

Some trends

Progressive specialization by type of product

Life Insurers could move away from products offering long term guarantees to others with profitabilities better reflecting the changing market conditions

Increase in fees along with a transfer of the risk to the customer

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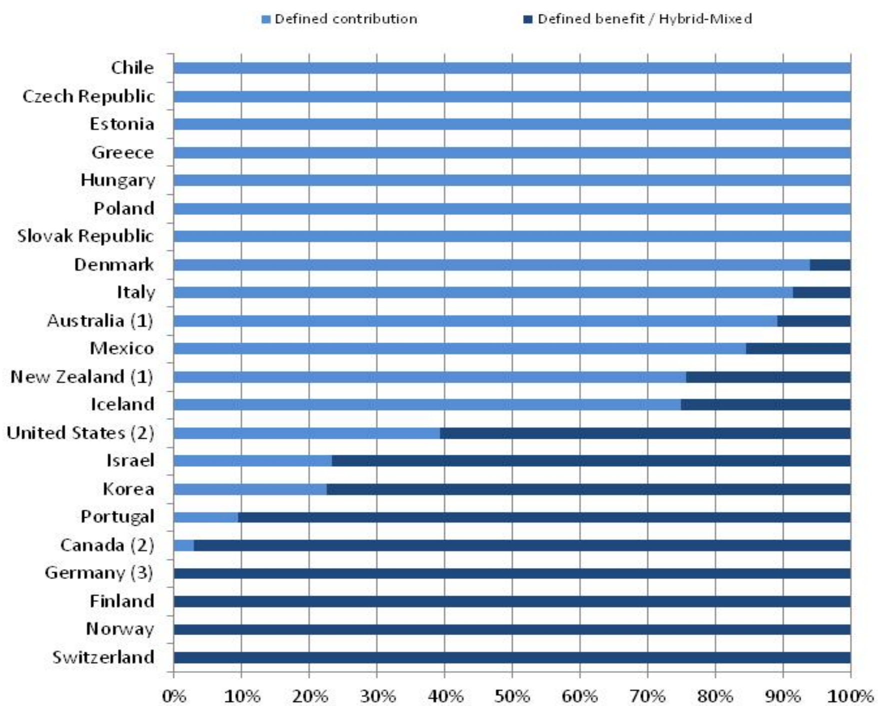
Overall impact over the pensions industry

Wide diversity of situations among countries: uncertain global effects



- **From DB to DC Pension funds: on average, DC moved from 35% of the accounts in 2001 to. 30% in 2011 (0.5% per year…).**

- **Some countries (Netherlands, UK) do not offer anymore DB products. However, important pending balances in DB determine its asset management policy**

- **The coverage of the longevity risks and an environment of low interest rates generate an increase of the life annuities price: sustainability issue**

- **In an environment of low interest rates, the DC pension funds accumulate less balances. Less attractive compared to other investment alternatives (ex real estate) as a mean to ensure resources for retirement.**

Section 3

Indirect impact of banking sector reform. Opportunities/challenges from the banking industry

I&P firms can look at banks in three different ways

Banks as investment target	Banks as providers of services	Banks as source of new business opportunities
Bank equity: lower returns, penalized under Solvency II	**Hedging**: higher cost of derivaties, less OTC, especially for IRS	**Buy divested banking assets:** insurance, trading desks
Bank debt: secured versus non secured	**Portfolio securitization (ABS, CDOs)**: increased cost, less tailor made opportunities	**Real estate:** competition/ partnership in real estate financing
Liquidity provision: banks could pay a premium to borrow liquity assets held by I&P	**Deposit takers:** banks will pay lower interests for their corporate deposits	**Project finance**: competition/ partnership in infrastructure financing

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Opportunities/challenges from banking industry

P&I Investment in banks' fixed income

DEMAND Solvency II

- **Pennalizes long maturities and high risk** → **Reduced appetite for long term Corporate debt:** → **CORPORATE FUNDING STRAIN**
- **Lower charges for sovereigns under standard model** → **More demand for Sovereigns** → **COMPETITION WITH BANKS. AAA RATIONING?**

SUPPLY -Basel III -Bail in

- **Unsecured debt to absorb losses**
- **Push towards 5-10 yr range**

→

- **Bail in debt: no appetite**
- **More demand for Covered bonds**
- **Debt in 5-10 yr range: push**

→ **HAPPY MARRIAGE IN MATURITIES … BUT PROBLEM OF ASSET ENCUMBRANCE?**

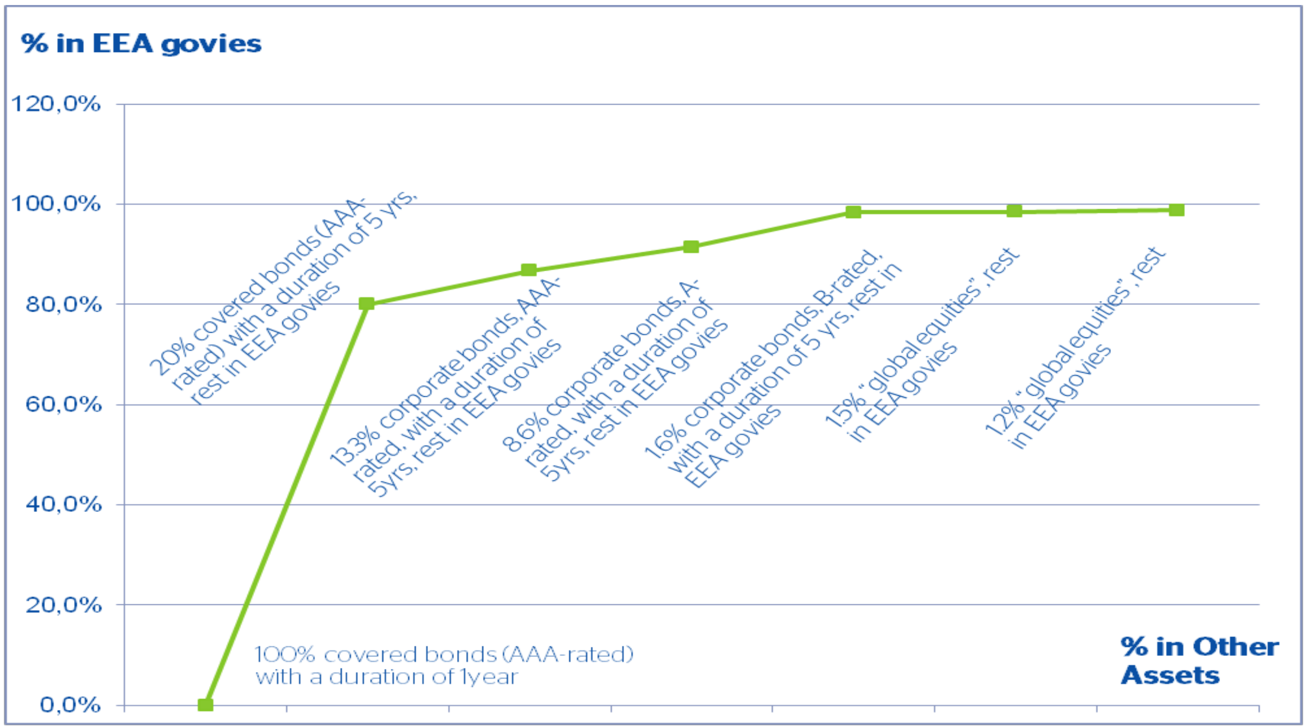
- Sovereign debt: the end of risk-free domestic sovereign? Sooner for Solvency II than for Basel III. EU sovereign crisis: bad timing
- Bank bail-in debt: investors base problem?

Section 3

Opportunities/challenges from banking industry

Potential AAA rationing problem: MORE DEMAND

Solvency II "Isocost" curve for different asset portfolios



SOLVENCY II: BIAS TOWARDS LONG TERM HIGH GRADE SOVEREIGN AND COVERED BONDS

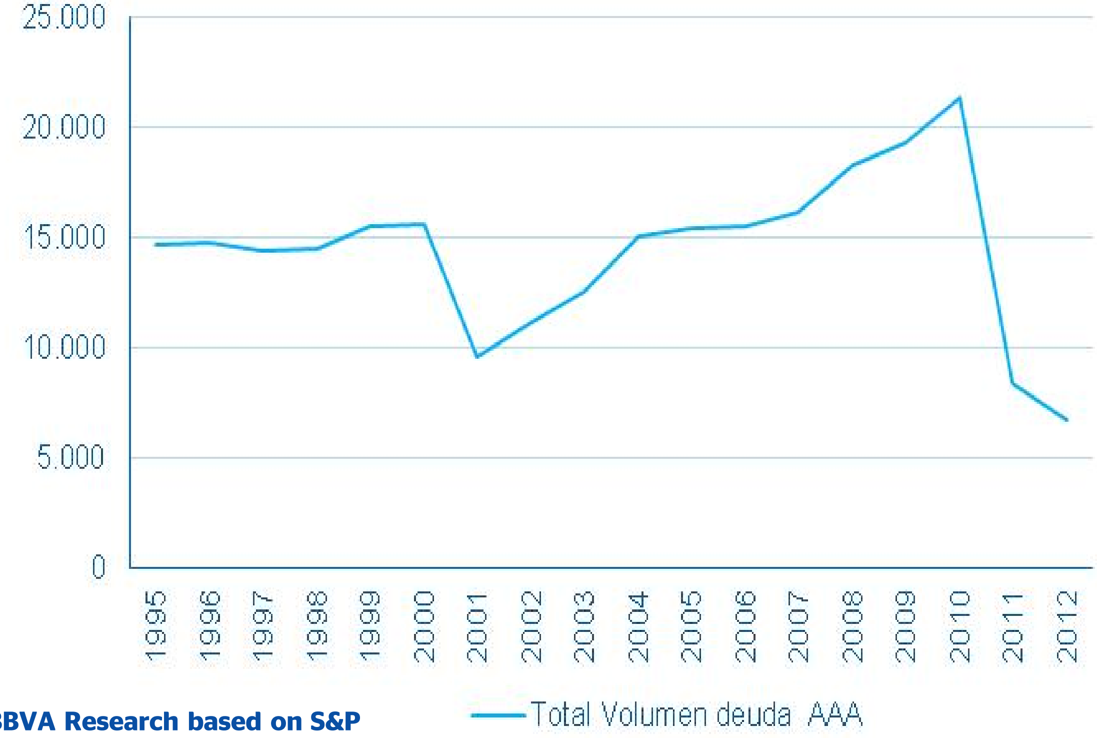
DISINCENTIVES FOR CORPORATE BONDS. COULD JEOPARDIZE BANK FUNDING

Section 3

Opportunities/challenges from banking industry

Potential AAA rationing problem: LESS SUPPLY

Evolution of global sovereign debt with AAA rating (constant, US$ bn)



EUROZONE CRISIS IS REDUCING THE SUPPLY OF AAA PUBLIC DEBT

Source: BBVA Research based on S&P

Section 3

Opportunities/challenges from banking industry

Banks as providers of services: hedging with derivatives

- **LESS SUPPLY:** push towards standardization (through higher capital requirements for non standardized derivatives) and mandatory CCP (higher collateral posting and margin requirements) will disincentive issuance of OTC by banks

- **MORE DEMAND:** I&Ps move towards shorter dated debt will make them more reliant on derivatives (IRS to hedge out the duration)

Higher cost associated to using derivatives

Section 3

Opportunities/challenges from banking industry

Banks as providers of services (continued): other services

- **Securitization:** heavily penalized both under Solvency II and Basel III. This increases significantly their cost for an insurer, both via higher own capital requirements and also via more costly provision of securitization services by banks

LESS SUPPLY AND DEMAND: LESS ACTIVITY, UNCERTAIN EFFECT ON PRICES

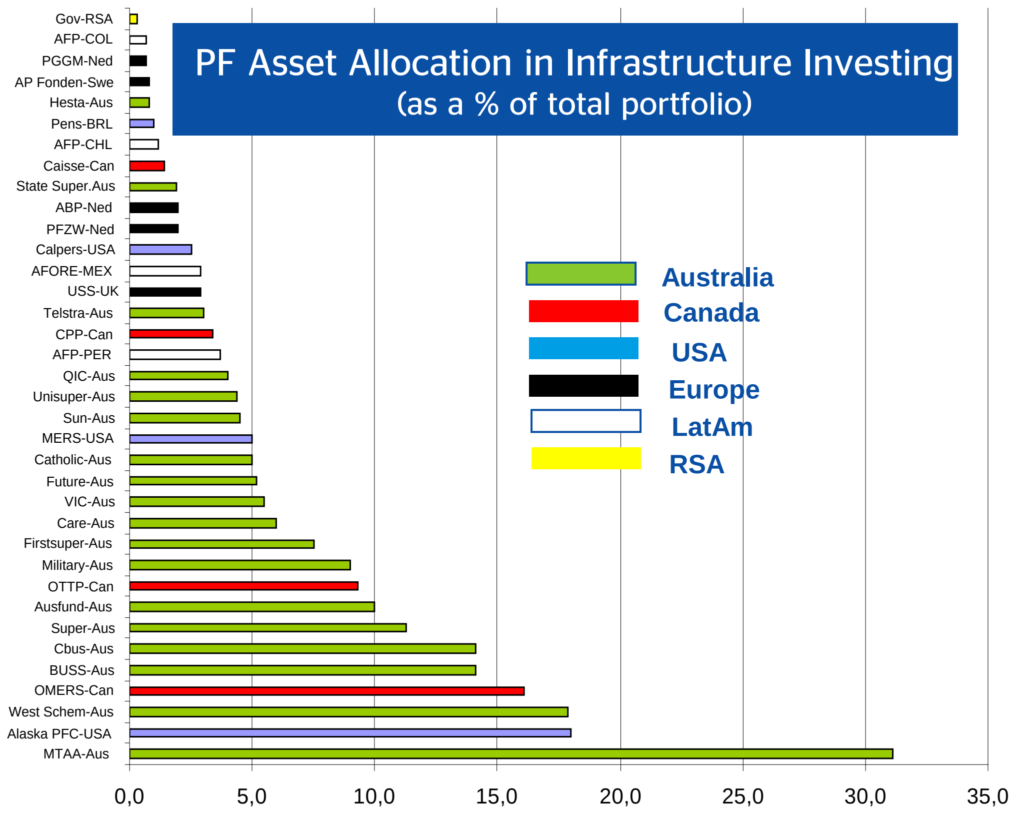
- **Corporate deposits:** they are penalized under Basel III new NSFR ratio. This will discourage banks from taking these deposits or reduce the return being offered, including to I&P

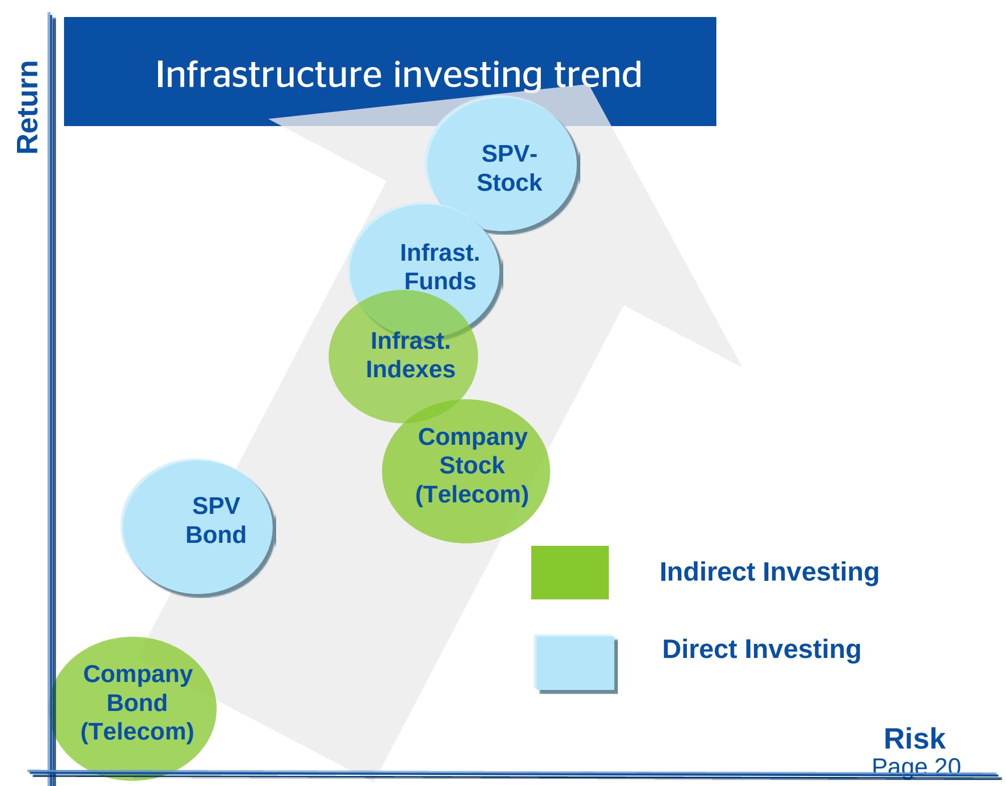
LOWER DEMAND BY BANKS, SAME DEMAND BY INSURERS: LOWER RETURN

Section 3

Opportunities/challenges from banking industry

PFs more involved in infrastructure asset financing due to structural drivers (longevity risks, low rate of returns)
Traditional 90% Bank-10% bond structure could shift towards higher PF weight





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Opportunities/challenges from banking industry

Banks as competitors/partners: real estate

- **Commercial real estate** loans are heavily penalized under Basel III through high reserve requirements: banks are scaling back
- **Solvency II** is less tough here: some insurance companies have started offering senior commercial real estate loans in god conditions

Banks scale back

I&P start being active

- On the **residential side**, Solvency II incentivizes EU insurers to hold relatively low LTV loans regardless of credit quality while Basel III gives a relatively better treatment to higher quality loans for a given LTV

Banks originate broad spectrum of mortgages

I&P buy the low LTV low credit quality mortgages

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Section 4

Conclusions

- **There is a big diversity among countries** in the starting situation of the I&P sectors, in terms of solvency levels and the diversification / riskiness of investment portfolios, which will lead to **different effects of Solvency II**
- … But there is a **common challenge:** how to reconcile a **more risk-sensitive regulation** with the **search for yield** in a world of persistently low interest rates
- This challenge is compounded by (i) **a very demanding banking regulatory reform** (ii) **the scarcity of high quality paper**, partly as a result of the sovereign debt crisis.
- **Some trends:**
  - Higher fees;
  - Lower appetite for corporate debt, including bank junior or senior debt
  - Higher appetite for sovereign debt … although the debate on zero risk-weight is open

Section 4

Conclusions

- **Some trends (cont):**
  - Higher cost of derivatives hedging
  - Less securitization activity, uncertain impact on prices
  - I&P more involved in infrastructure financing, although there are limits to this process
  - More Real Estate activity of Insurance sector
- **Banking regulation will put additional strain on the relationship with banks**… but **new potential opportunities could arise** if the regulatory framework is adequate. The potential shift of certain banking activities to the shadow banking will also be an issue. **P&I as shadow banks?**
- **Regulators of banks, pensions and insurance sectors should** (i) **analyze the interactions of new regulations,** the trade-offs and the risks, (ii) **ensure their consistency** as well as allineate the incentives and (iii) **revise those regulations that create wrong incentives** in the long run.