INSURANCE

Q&A: Eiopa approach wrong on government bonds, says Ivass director

Corinti: Modelling sovereign risk should not be a Pillar 1 requirement

Callum Tanner

@callumtanner755

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this exclusive interview with *Risk.net*, Alberto Corinti of Italian regulator the Istituto Per La Vigilanza Sulle Assicurazioni (Ivass) explains his differences with Eiopa's position.

Corinti is a member of both the board of directors at Ivass and the managing board at the European Insurance and Occupational Pensions Authority (Eiopa). He is also head of financial stability at the International Association of Insurance Supervisors (IAIS).

Corinti says he is concerned about Italian insurers' exposure to Italian sovereign debt (BTPs) and agrees that reducing the concentration risk of large sovereign holdings is necessary. But the process should be gradual, he says. The situation is complicated, he adds, by the fact that Italian insurers' returns on BTPs have helped firms to match their liabilities and mitigate the threat of long-term low interest rates – the so-called 'Japanification' scenario.

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Corinti goes on to highlight the key challenges of building an international capital framework, a project that already is being delayed by disagreement between European and US regulators.

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Risk.net: **Is there disagreement among supervisors about the treatment of sovereign risk?**

Alberto Corinti: We share the view that there is a risk in sovereign bonds because everyone can see there is volatility in their value. What we don't agree with is the way in which now, at the European level, we are dealing with sovereign risk. I think more analysis using a holistic approach is necessary.

At the European Systemic Risk Board (ESRB) and European Central Bank (ECB) – so in the banking sector as well – regulators are discussing how to measure the risks of sovereigns and which risks need to be taken into account, looking especially at whether it is just the movement of spreads that is material or default risk as well. What is important is to have a harmonised overall approach that also takes into account all the collateral effects of the capital charges, at both micro and macro level.

What is your view?

AC: Such an approach should take into consideration the fact that the peak of volatility recorded in 2011 was substantially due to geopolitical reasons and was not fully connected to credit risk considerations. Markets were betting on the collapse of the euro until the “whatever it takes” pronouncement from ECB president Mario Draghi. This is why we believe further analysis is necessary before injecting such volatility into the regulatory framework.

There is also the question of how to introduce a new capital charge and if it is necessary to set a transitional for this measure. The introduction of a Pillar 1 capital requirement requires a holistic approach that requires simultaneous consistency across the banking and insurance sectors. It also needs to address companies using the standard formula and not just an internal model.

So we are not aligned with Eiopa’s opinion because we do not think it’s the best way to approach the issue. In our opinion it does not contribute to a level playing field across Europe. Besides, it also creates discrimination between companies using an internal model compared to those using the standard formula.

And how are you approaching this issue in Italy?

AC: What we are doing in Italy is to control the risk by asking firms to consider sovereign risk in their Orsas and check whether the potential movement of the spread is sufficiently mitigated or not. In other words, we would like firms – we have sent recommendations to companies on this recently – to appropriately address this risk in their Pillar 2 assessments. This could also lead to a capital charge, if necessary, depending on individual circumstances. But we do not think a generalised introduction of a capital charge at this stage is appropriate.

We are aware of the fact that insurance companies in Italy have an important percentage of Italian sovereigns on their balance sheets. They also have such a high concentration because of how Solvency I regulation was shaped and the way that directive was transposed in Italy. But, it is actually this concentration and high exposure to Italian sovereigns that is protecting Italian insurers from the impact of the current low-yield environment.

In Italy, the risk of spread movements on the sovereign over time is actually mitigated by the fact that companies are generally well matched and not forced to sell. Our supervisory activity aims to verify for each company whether it is exposed to forced sales and find out the potential maximum negative movement of the spread that could put [the company in question] in a critical situation.

Rating agencies have said large groups have too much exposure to sovereign debt. Do you think Italian insurers are overexposed to this asset class?

AC: If I do not take into account wider considerations, my answer is obviously yes. On average, Italian insurers have a 60% exposure to Italian sovereign debt, but we need to recognise this has protected insurance companies from other types of risks. In particular, interest rate risk.

A reduction in the concentration risk, which is something we are urging insurance companies to think about, in terms of increased diversification, needs to be a gradual process.

From a macro-prudential perspective, the concentration cannot be dramatically reduced because this could have undesired effects - for example, on the price of all sovereign debt if insurance companies start selling all their government bonds quickly.

From a micro-prudential perspective, the 60% concentration in Italian sovereigns is actually supporting guarantees to policyholders. If insurers start to reduce concentration they would be less exposed to the movement of government bond spreads in the future, but then they could become more exposed to interest rate risk and the risk of not being able to satisfy guarantees. At the moment the latter risks are certainly more of a concern than the spread risk of the Italian sovereign.

Should standard formula firms be getting ready for a change to the 0% risk charge for sovereigns in the next couple of years?

AC: I don't think 'a couple of years' is going to be sufficient time, but it's likely that eventually there will be a capital charge.

After the implementation of Solvency II, Eiopa will analyse this issue. I tend to think the first occasion Eiopa reviews the calibration, which is scheduled in three years, could be when sovereign risk will be taken into account in capital requirements.

But it is not just a question of Solvency II, sovereign risk charges also need to be harmonised with the banking sector, so it will also depend on the timetable of other regulators.

What are the biggest challenges facing Italian insurers?

AC: It's really about getting ready for Solvency II from an organisational point of view, especially with regard to governance requirements. In terms of financial challenges, I would say Italian companies do not have, on average, a specific concern in terms of their solvency position.

One of the main problems for the European insurance sector is the low-yield environment and the impact this has on companies, especially life insurers. As I said, Italian insurers are not as exposed as other European companies on this issue. Low interest rates are still a concern, but thanks to certain characteristics of Italian Solvency I regulation and to appropriate asset-liability management, the exposure to low interest rates is less concerning compared with other countries.

Why are Italian insurers less exposed than others to low rates?

AC: First of all, the level of the guarantees is lower; secondly, the length of the liabilities is shorter; and, thirdly, Italian companies in life insurance have well-matched cashflow between assets and liabilities. This allows companies to be protected against spread and reinvestment risk.

Both in the Eiopa stress test and other publications, there is data that actually confirms Italian insurers are well matched between assets and liabilities on average. Obviously, we are checking individual companies to make sure they stress the situation and check what the impact would be on their ability to pay policyholders if interest rates remain lower for longer.

The risk-free curve reflected by the market has been even lower than the Japanese scenario included in Eiopa's stress test, so the situation is actually worse than what has been stressed in the exercise, but, again, it comes back to good matching. Italian companies can get the maturity of the instrument to pay the policyholders.

However, Italian companies recognise low interest rates are a problem for them as well and have begun to change the design of products in order to include lower or different guarantees. They are now moving towards liabilities that are more flexible by offering guarantees that are linked – totally or partially – to the performance of the market.

Do you accept criticism that the final calibration of Solvency II has been compromised too far by the long-term guarantee package?

AC: If you are referring to the ultimate forward rate, for example, I understand why some think this could be a problem in the low rates environment. You could think 4.2% is too high, but I would refrain from saying it is wrong. In the end, all of the calibrations have been a result of negotiation and compromise. The calibration of Solvency II is a good starting point and then calibration should be refined over time.

So, I can understand that having an ultimate forward rate of 4.2% could be criticised. But, in any case, we have companies with relatively short liabilities – on average seven years – so this part of the curve is less relevant for us.

On long-term guarantees, we support this package because we need some kind of mechanism that mitigates excessive volatility, especially the volatility adjustment within a very transparent framework. You could say 65% [of the risk-adjusted spread of assets] is too high or too low, but it is very difficult to say the calibration is wrong. We need to check again how it works when it is implemented.

What are your priorities as head of financial stability at the IAIS?

AC: The IAIS's priority is to define the higher loss absorbency (HLA) requirements by the end of this year. We are committed to carrying out this work in a very short timeframe.

Another priority is the revision of the methodology to identify those groups with systemic relevance, known as G-Siis. This revision has been triggered by some disagreement with regard to the treatment of reinsurers, but it will be a revision that takes into account other parts of the methodology and tries to improve it as a whole, especially the shortcomings that have been highlighted by these first three years of application.

In November we will likely issue a consultation paper on possible changes, and this review should help to design a new methodology that will be applied to the designation exercise planned for 2016.

***Risk.net* understands US regulators disagreed with the assessment methodology that would have designated Berkshire Hathaway a G-Sii. Should it be designated a G-Sii?**

AC: It is true the disagreements came from US colleagues, but there was also concern from other supervisors. I cannot conceal that there are still divergent views, but we are working hard to reconcile disagreement and finalise something we can all agree on.

The treatment of reinsurance activity is the contentious point, but there are many aspects of the methodology under review now, so I cannot say any more than that.

With resistance from US regulators, is there a risk that the Insurance Capital Standard (ICS) will never happen?

AC: The clear commitment from the IAIS is to finalise the ultimate goal of developing a capital standard based on a single methodology. This is something that will be achieved. There is no specific date attached to it, but I think it will certainly be achieved.

Do you have a personal view on the systemic threat of insurers and reinsurers?

AC: In my opinion, both insurers and reinsurers can be systemic or not systemic, depending on their specific activities, so my personal view is very much in line with what the IAIS issued one year ago.

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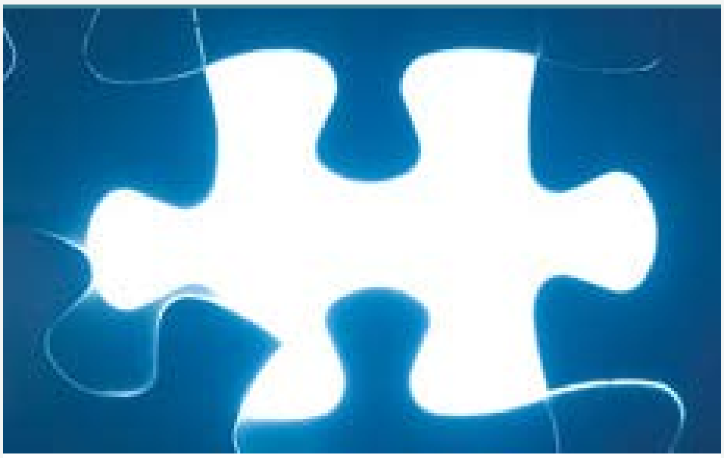

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