Finance for growth, the role of the insurance industry

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Agenda

I. Insurance industry and economic growth

II. Supply and access to suitable assets

III. Regulatory disincentives
I. Insurance industry and economic growth
Insurance contribution to economic growth

• In general, insurance makes a major contribution to economic growth and development because:
  – It facilitates economic transactions by providing risk transfer and indemnification;
  – It encourages risk management and the promotion of safe practices;
  – It encourages stable and sustainable savings and pension provisions;
  – It promotes financial stability by providing long-term investment in the economy.

• The relationship between insurance and economic growth has been less investigated than the one between finance and growth. There is evidence that:
  – on the one hand, insurance is more developed in rich countries;
  – on the other hand, insurance has a structural and positive causal impact on economic growth.
Insurance companies are Europe’s largest institutional and long-term investor

### European institutional assets under management — 31 December 2012

<table>
<thead>
<tr>
<th>Category</th>
<th>Assets (€bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance companies</td>
<td>€8 400bn</td>
</tr>
<tr>
<td>Pension funds</td>
<td>€4 200bn</td>
</tr>
<tr>
<td>Retail investors</td>
<td>€3 900bn</td>
</tr>
<tr>
<td>Sovereign wealth funds</td>
<td>€600bn</td>
</tr>
<tr>
<td>Endowments and foundations</td>
<td>€300bn</td>
</tr>
<tr>
<td>High-net-worth individuals</td>
<td>€1 200bn</td>
</tr>
</tbody>
</table>

*Sources: Insurance Europe, OECD, EFAMA, SWF Institute, Forbes*
Investing is a consequence of insurance business model (1/3)

- **Investment** is core to the provision of insurance products but **is driven by the nature of our liabilities** and our need to match our liabilities.
Investing is a consequence of insurance business model

The global insurance industry trend

- Maintain/grow inflows of premiums is crucial for insurance companies investment capacity
- The global insurance industry gained momentum in 2014, even though the economic environment improved only marginally

Life premium growth is expected to remain fairly solid in the advanced regions in 2015 and increase in the emerging markets.

The outlook for the non-life industry in advanced markets is more moderate.
Investing is a consequence of insurance business model

**The actual protection gap**

(3/3)

- However, evidence shows that there is still a wide protection gap in many countries.

- In order for insurance industry to continue to grow, companies must actively work to reduce it.

- This would imply a higher investment capacity.

### Global Property protection gap

<table>
<thead>
<tr>
<th>Protection gap</th>
<th>Natural catastrophe gap</th>
<th>General underinsurance</th>
<th>Total underinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Loss</td>
<td>Premiums</td>
<td>Loss equivalent</td>
</tr>
<tr>
<td><strong>Base of calculation</strong></td>
<td><strong>USD billion</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High income</td>
<td>41</td>
<td>18</td>
<td>15</td>
</tr>
<tr>
<td>Middle income</td>
<td>51</td>
<td>36</td>
<td>29</td>
</tr>
<tr>
<td>Low income</td>
<td>61</td>
<td>31</td>
<td>24</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>153</strong></td>
<td><strong>85</strong></td>
<td><strong>68</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Protection gap</th>
<th>% of GDP</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High income</td>
<td>Middle income</td>
<td>Low income</td>
</tr>
<tr>
<td>Natural catastrophe gap</td>
<td>0.12%</td>
<td>0.36%</td>
<td>0.22%</td>
</tr>
<tr>
<td>Loss equivalent</td>
<td>0.04%</td>
<td>0.20%</td>
<td>0.09%</td>
</tr>
<tr>
<td>Total</td>
<td><strong>0.25%</strong></td>
<td><strong>0.11%</strong></td>
<td><strong>0.36%</strong></td>
</tr>
</tbody>
</table>

Source: Swiss Re Economic Research & Consulting.
Investments of European Insurers

- As at 31 December 2014, the European insurance industry had almost €9 900bn invested in bonds, company shares and other assets -
  - The investment portfolio of European insurers is equivalent to 63% of the EU GDP
Investments of European Insurers

Structure of European Insurers’ Portfolio - 2004-2012
Investments of Italian Insurers

As at 31 December 2014, the Italian insurance industry had almost **€630 bn invested** in bonds, equities and other assets.

**Total investments**

€ Mln

<table>
<thead>
<tr>
<th>Year</th>
<th>Life</th>
<th>Non-life</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>388.507</td>
<td>77.890</td>
</tr>
<tr>
<td>2008</td>
<td>358.205</td>
<td>76.471</td>
</tr>
<tr>
<td>2009</td>
<td>410.827</td>
<td>78.652</td>
</tr>
<tr>
<td>2010</td>
<td>442.574</td>
<td>74.441</td>
</tr>
<tr>
<td>2011</td>
<td>437.347</td>
<td>74.037</td>
</tr>
<tr>
<td>2012</td>
<td>451.255</td>
<td>75.720</td>
</tr>
<tr>
<td>2013</td>
<td>483.901</td>
<td>79.059</td>
</tr>
<tr>
<td>2014</td>
<td>549.870</td>
<td>79.659</td>
</tr>
</tbody>
</table>

**% change**

- **Non-life**
  - 2007: -1.8
  - 2008: 2.9
  - 2009: -2.1
  - 2010: -0.5
  - 2011: 2.3
  - 2012: 4.4
  - 2013: 0.8

- **Life**
  - 2007: -7.8
  - 2008: 14.7
  - 2009: 7.7
  - 2010: -1.2
  - 2011: 3.2
  - 2012: 7.2
  - 2013: 13.6

- **Total**
  - 2007: -6.8
  - 2008: 12.6
  - 2009: 6.2
  - 2010: -1.1
  - 2011: 3.0
  - 2012: 6.8
  - 2013: 11.8

**Excluded professional reinsurers**

**calculated in homogeneous terms**
Investments of Italian Insurers

Structure of Italian Insurers’ Portfolio - 2008-2014

- Italian government bonds are still the most important asset class in Italian insurance portfolios
How to turn the insurance industry’s potential capacity into direct investments in real economy?

• The European insurance industry has a significant investment potential which needs to be matched with suitable long term assets

• European insurers are interested in asset classes which can have the most immediate impact on growth, such as:
  – Infrastructure (debt, equity)
  – Securitisations
  – Credit investments

• ...A combination of measures and actions will be needed to turn the insurance industry’s potential capacity into real investments

Improve supply and access to suitable assets:
- need for a sufficient supply of products which meet risk/return criteria for liabilities

Remove regulatory disincentives
II. Supply and access to suitable assets
Need for suitable long-term assets

- At European level a number of initiatives have been launched in recent years with the aim of encouraging investment in the real economy through long-term investments.
- These initiatives contributed to increase the interest of insurance companies in new investment tools.

Why?

- Diversification
- Higher returns
- Matching with long-term liabilities
Need for suitable long-term assets

Infrastructure investments

• Insurers are interested in infrastructure investments because of their features:
  – long-term duration
  – low correlation with other asset classes
  – higher returns with respect to «traditional» investments
  – default risk mainly due to physical/technical factors

• In particular, they are interested in infrastructure investments with:
  – stable and predictable cash flows
  – low correlation with financial market movements
Need for suitable long-term assets

Securitisations and Direct lending

• Insurers will be attracted by these instruments only in case of:
  – High quality issuance
  – Returns satisfying commitments towards policyholders
  – An adequate guarantee framework
  – Products standardisation and transparency of underlying portfolios

• In a medium-long term perspective the appetite for private credit risk will be significantly fostered by lower exposures to Govies and the increase of insurance liabilities

• However, lending on a large scale is a very different business from insurance.
  – So it is crucial that a more efficient market for private credit risk is established.
Insurers investing in the real economy

The situation in Italy

• Italian legislation has progressively widened the range of investment opportunities for the insurance industry in line with the European trend.

• An ANIA survey on investments backing technical provisions has shown that, as at 31 March 2015, the percentage of innovative “financial instruments” used by a sample of Italian companies* was around 6%.

• Despite this still low figure, there is evidence of a growing interest in this type of financial instruments.

*Representing 60% of the market in terms of total investments

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**Type of investments**

<table>
<thead>
<tr>
<th>Investments (stock) as at 31 March 2015 (€ mln)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITALIAN ISSUERS</td>
</tr>
<tr>
<td>----------------</td>
</tr>
<tr>
<td>a) Credit or debit funds</td>
</tr>
<tr>
<td>b) Minibond</td>
</tr>
<tr>
<td>c) Mortgage Backed Securities</td>
</tr>
<tr>
<td>d) Securitisations or funds of a) , b) o c)</td>
</tr>
<tr>
<td>e) Private placement</td>
</tr>
<tr>
<td>f) Direct lending</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>
III. Regulatory disincentives
Avoidance/removal of regulatory disincentives

• Good regulation is important for a healthy industry
• A raft of regulatory changes can affect insurers investment behaviour, including:
  – Prudential (Solvency II)
  – Accounting
  – Derivatives
• Regulation and design of the supply is also a key
• Regulations must take into account the distinctive characteristics of the insurance industry
The case for Solvency II

• What is needed **in the short-term** (before its entry into force)
  – Securitisations
  – Infrastructures

• Some thoughts **for the long-term** (2018 review process)
Solvency II: short-term adjustments

Securitisations

- Solvency II Delegated Regulation introduced some significant improvements
  - i.e. reduced calibration for «high quality» (Type I) securitisations

- EC Proposal for simple, transparent and standardised (STS) securitisations contains a number of further positive elements
  - e.g. junior tranches included in the scope of STS

- Need for further reduction of the current Solvency II calibrations in order to better reflect the true risks on the insurers that do not represent a barrier to investment
  - e.g. capital charges for securitisations of residential loans to be capped at the level of charge applied to the underlying pool of residential loans
Solvency II: short-term adjustments

Infrastructures

- No specific treatment in Delegated Regulation
- EC asked EIOPA for advice
- Draft EIOPA advice: a step in the **right direction, but improvement needed**:
  - **definition of infrastructures is too narrow** (should be extended to corporates operating in infrastructures asset). **More flexibility in the area of criteria**
  - **recalibration needed**:
    i. If a treatment within the spread risk module is chosen, a **combination of EIOPA’s liquidity and credit risk approach** should be considered;
    ii. a **proposal for a calibration in the counterparty default risk module** should be included in EIOPA’s advice;
    iii. **distinguish between listed and non-listed infrastructure equity**
Some thoughts for the long-term

• Using market values may exaggerate the true exposure of the balance sheet to temporary market volatility and therefore force the company to hold significant extra capital buffers to cope with the large volatility
  
  – The “market consistent” value of liabilities is obtained by discounting future cash flow with risk-free rates (proxied by euro swap rates). During periods characterized by high volatility in financial markets, average asset values tend to decrease while “safe” assets will benefit from “flight to quality” effects, which will cause their market value to increase considerably

  ✓ Thus, the capital position of insurers might deteriorate even if the adjustment of interest rates is only temporary and liabilities are due in a distant future (recent examples: 2008 corporate bond and 2011 government bond crisis)

• Using a 1 year VAR for assets which can be held long-term may exaggerate the exposure to market movements and lead to capital requirements being set too high than required, at least for specific asset classes
  
  – (Mladina, 2014) “equity returns show more volatility and tail risk at short horizons than at long horizons”
  
  – (Persaud, 2015) “to a life insurer, what matters is not the price of an asset or the risk of holding it tomorrow or at the end of the year but the risk at the point of maturity of the policy”
Some thoughts for the long-term

*Equity investments of European insurers*

- According G-30 (2013) European insurers reduced their allocation to equities by 11 percentage points (almost 1 trillion euros compared to actual total assets) **from 2001 and 2010**, while in the US the share of equities in insurance portfolios remained almost flat
  - This started as an internal risk management approach – encouraged by supervisors - after the collapse of Equitable Life (2000)
  - An obvious question is whether the different trend is also related with the adoption of a «Market Consistent Approach» for Solvency II while in the US this is not the case

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**EXHIBIT 1A**

<table>
<thead>
<tr>
<th>Western European Insurers' Financial Assets</th>
<th>US Life Insurers' Financial Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent, USD Trillion, 2010 exchange rates</td>
<td>Percent, USD Trillion</td>
</tr>
<tr>
<td>2001</td>
<td>0.5</td>
</tr>
<tr>
<td>2004</td>
<td>0.5</td>
</tr>
<tr>
<td>2007</td>
<td>0.4</td>
</tr>
<tr>
<td>2010</td>
<td>0.4</td>
</tr>
</tbody>
</table>

**EXHIBIT 1B**

European Insurers have been decreasing their allocation to equities outside their unit-linked businesses since 2001, in contrast to US Insurers.

**EXHIBIT 2**

European Pension Funds have been shifting out of equity, toward bonds and alternative assets.

*NOTE: Numbers may not sum due to rounding.*

*SOURCE: McKinsey Global Institute, "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape" (December 2011).*
• Adjustments were made to the market consistent approach to better reflect the long-term nature of the business and allow insurers to continue to offer long-term guarantees backed by long-term investments:
  – For example, on the balance sheet measurement, adjustments have been introduced to the discount rate used to value liabilities (e.g. the “Matching Adjustment”, “Volatility Adjustment”)
  – Transitional measures envisaged for the calibration of equity risk
• Concerns remain over the effectiveness of the adjustments as these are regarded to be very conservative in their calibration and restrictive where they can be applied
• Rather than seen as legitimate improvements to better reflect the true risks and economics of the business these adjustments are seen by some as aberrations from the pure and correct market approach (Ayadi et al., 2012)
• Research is needed on this topic
  – The Solvency II review, planned for 2018, should find proper solutions to these issues in order to preserve the insurance business model (in particular, Life)
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