ANIA
Associazione Nazionale
fra le Imprese Assicuratrici

Deleveraging: a Diversification Opportunity for Insurance Company ?

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Agenda

I. The credit crunch

II. Spreads on bonds

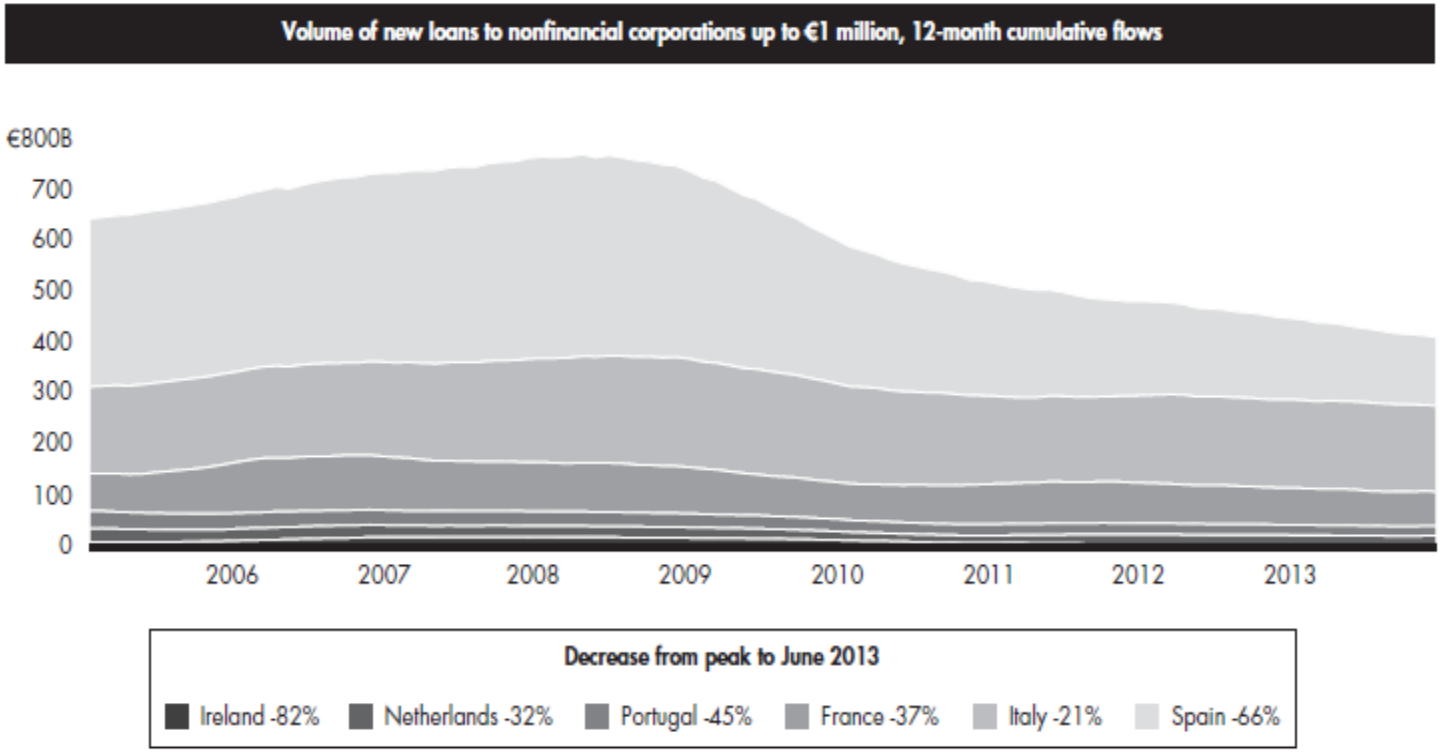
III. Credit market conditions in Italy

IV. Investment of European Insurers

V. Solvency II

VI. Conclusions

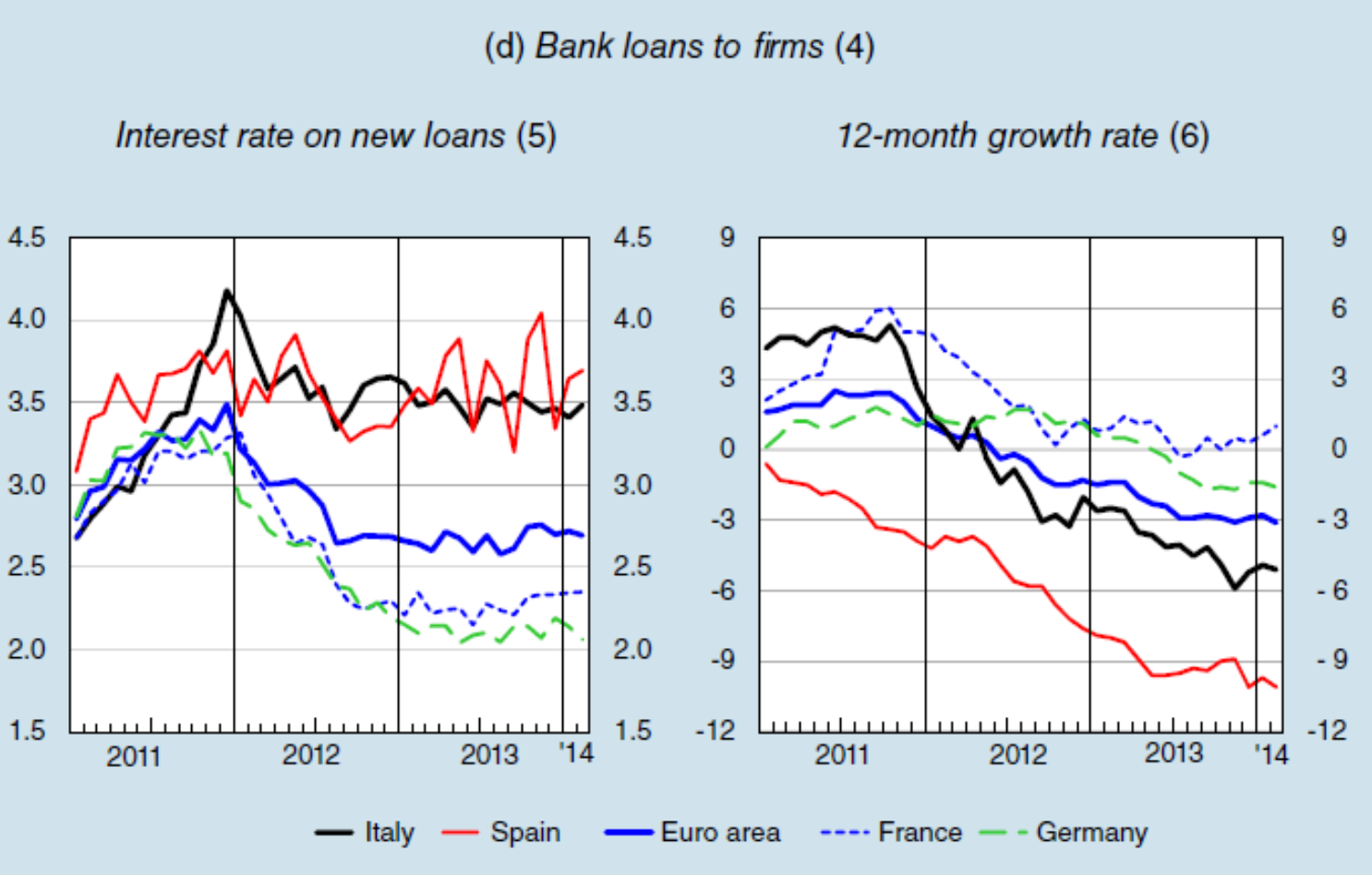
The credit crunch
New loans to non-financial firms up to 1 mln euro



Note: Percentage decrease calculated on a country-by-country basis from pre-crisis peak to June 2013
Source: National central banks

Source: Restoring financing and growth to Europe's SMEs | Bain & Company, Inc. | Institute of International Finance

The credit crunch
Loans to non-financial firms resident in the euro area



Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

The credit crunch
Supply of credit, according to banks

Supply of credit, according to banks: 2009-2013Q3

	Tightened, most recent three months		Eased, most recent three months	
	Number of quarters	Average tightening, %	Number of quarters	Average easing, %
France	9	-13.8	5	3.8
Ireland	5	-23.8[1]	0	–
Italy	16	-27.3	2	12.5
Netherlands	15	-41.8	0	–
Portugal	16	-66.3	3	33.3
Spain	9	-21.1	1	10.0

Note: Response to ECB survey question 1: "Over the past three months, how have your bank's credit standards as applied to the approval of loans or credit lines to enterprises changed?"; An increase in tightening corresponds to a negative number; average tightening/easing refers to the net percentage of banks indicating a tightening/easing of credit standards; [1]Ireland only reports a diffusion index rather than a net percentage, weighting answers so that "considerably" is given more weight than "somewhat."
Source: ECB Bank Lending Survey

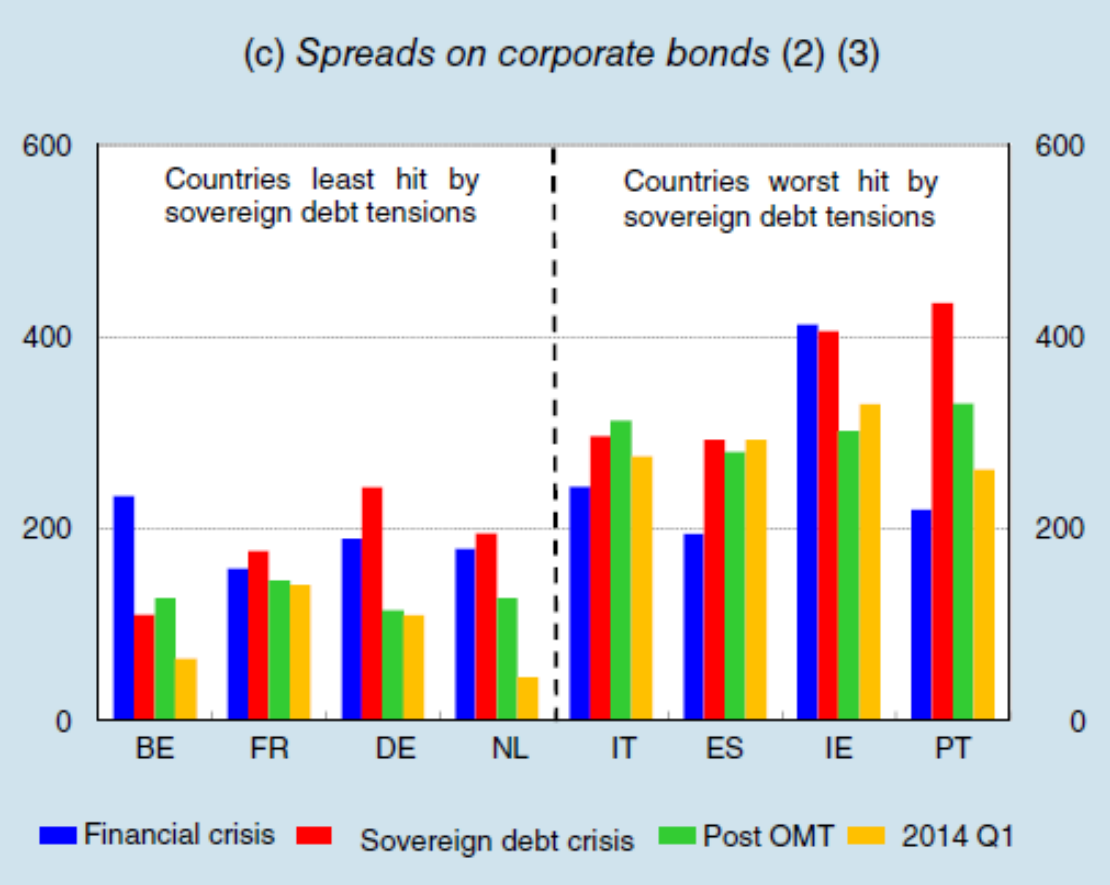
Source: Restoring financing and growth to Europe's SMEs | Bain & Company, Inc. | Institute of International Finance

The credit crunch
Private sector financial debt at end Q3 2013

	Private sector financial debt at end Q3 2013	
	Households	Non-financial firms
Italy	44.9	81.9
Germany	57.6	57.0
France	57.0	104.3
Spain	78.1	130.7
Netherlands	126.9	93.6
Belgium	56.8	192.3
Austria	53.8	108.4
Finland	66.6	115.8
Greece	64.3	64.9
Portugal	88.8	166.2
Ireland	102.5	212.8
Euro area (3)	64.5	100.6
United Kingdom	92.2	92.1
United States	78.5	80.5
Japan	63.4	104.4
Canada	94.7	98.7

Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Spreads on bonds



Average annual asset swap spreads at issue, in basis points, on bonds (placed on the international market) of banks or of firms whose parent company is located in the country indicated on the horizontal axis. The periods of time are: financial crisis, from 2007 Q4 to 2010 Q2; sovereign debt crisis, from 2010 Q3 to 2012 Q2; post OMT, from 2012 Q3 to 2013 Q4.Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Spreads on bonds in Italy

Yield spread between bonds issued by Italian and German banks and firms
(basis points)

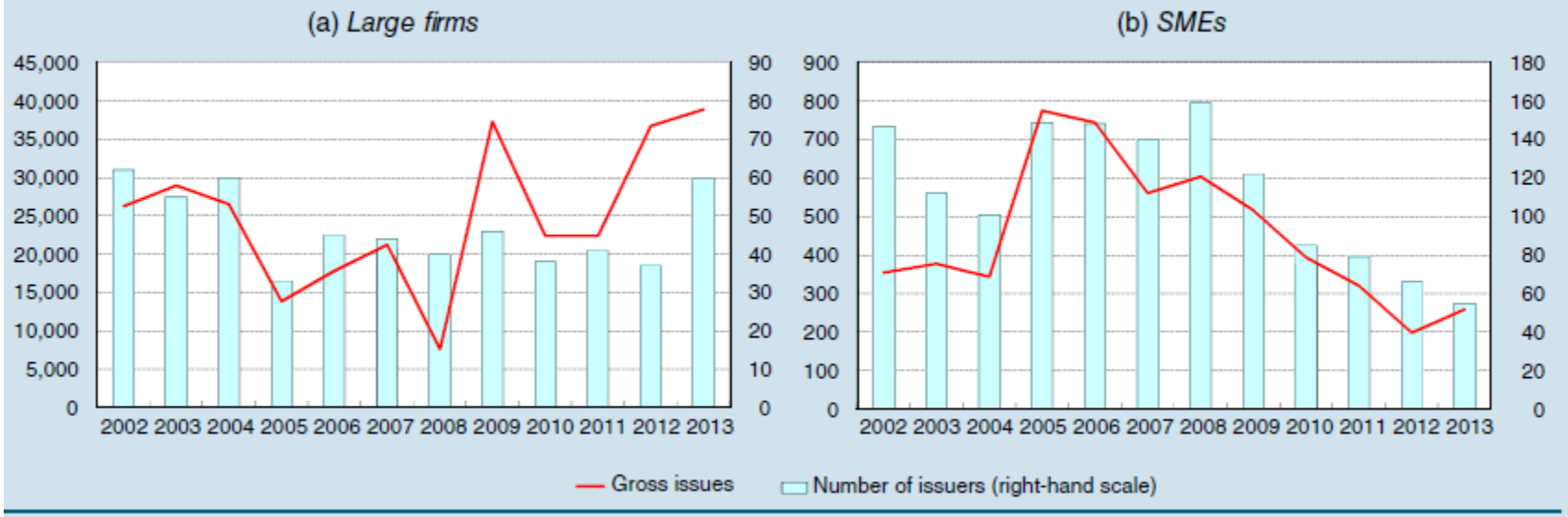
	ascribable to		
		type of issuer or type of security	country of residence (2)
	(1)	(2)	(3)
Financial crisis (4)	59	59	0
Sovereign debt crisis (5)	139	37	102
Post OMT (6)	187	146	41

Source: Based on Dealogic, Bloomberg and Thomson Reuters Datastream data.
(1) Differential between the average value, in the period indicated, of asset swap spreads at issue of Italian banks' and firms' bonds and the average value of those of German banks' and firms' bonds. – (2) Estimate of the part of the differential with respect to Germany (first column) due to the features of securities (rating, volume, duration, currency) and issuers (rating, size, sector), calculated as the difference between the first and the third column. – (3) Estimate of the part of the differential with respect to Germany (first column) due to the fact that the issuer's parent company is located in Italy, not in Germany. The estimates, which take account of the characteristics of the securities and issuers in note (2), are based on over 7,000 issues by euro-area firms in 2006-2013. – (4) From 2007 Q4 to 2010 Q2. – (5) From 2010 Q3 to 2012 Q2. – (6) From 2012 Q3 to 2013 Q4.

Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Spreads on bonds

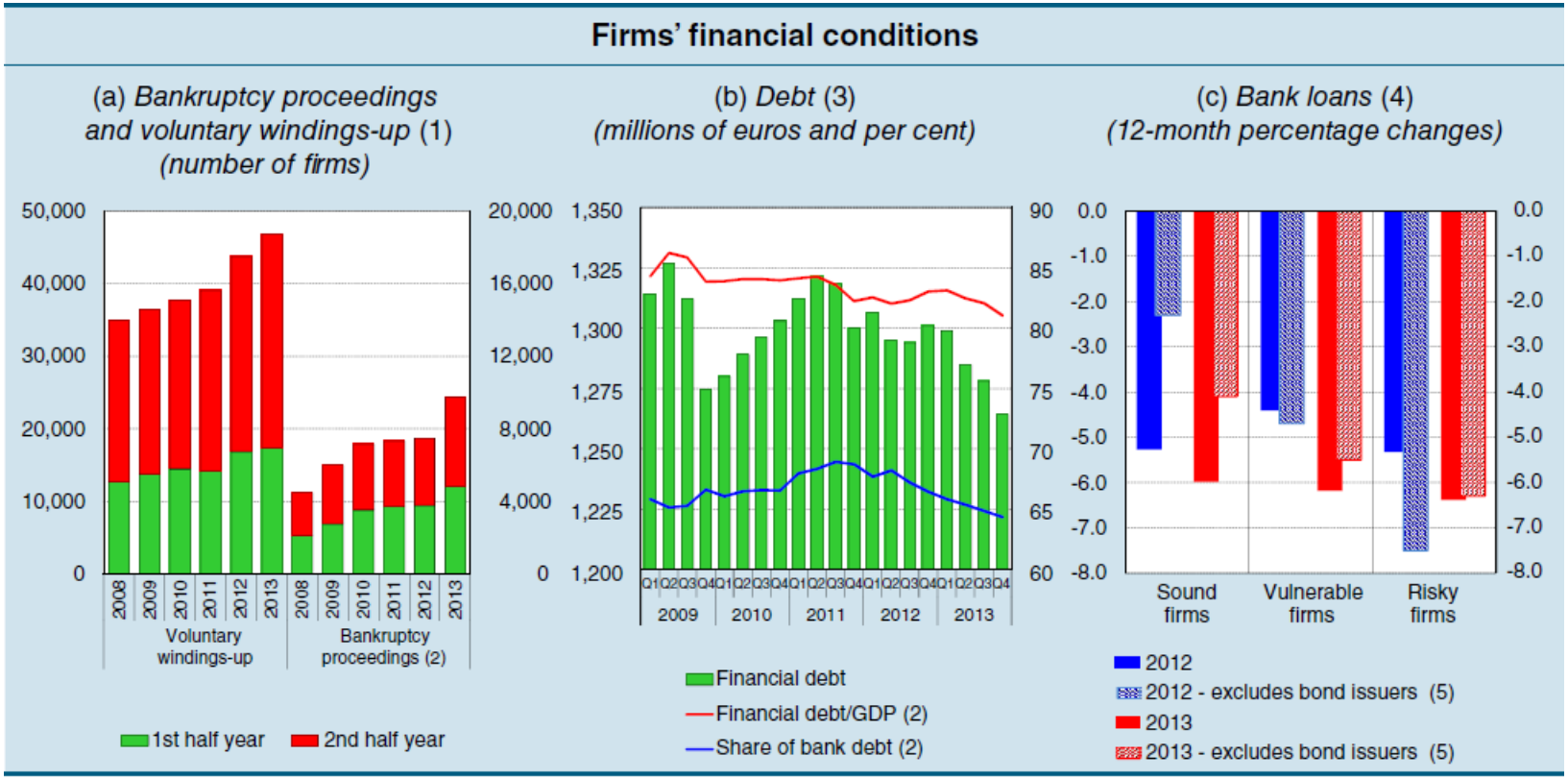
Bond issues by firm size
(millions of euros and units)



Sources: Bank of Italy and Dealogic.

Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

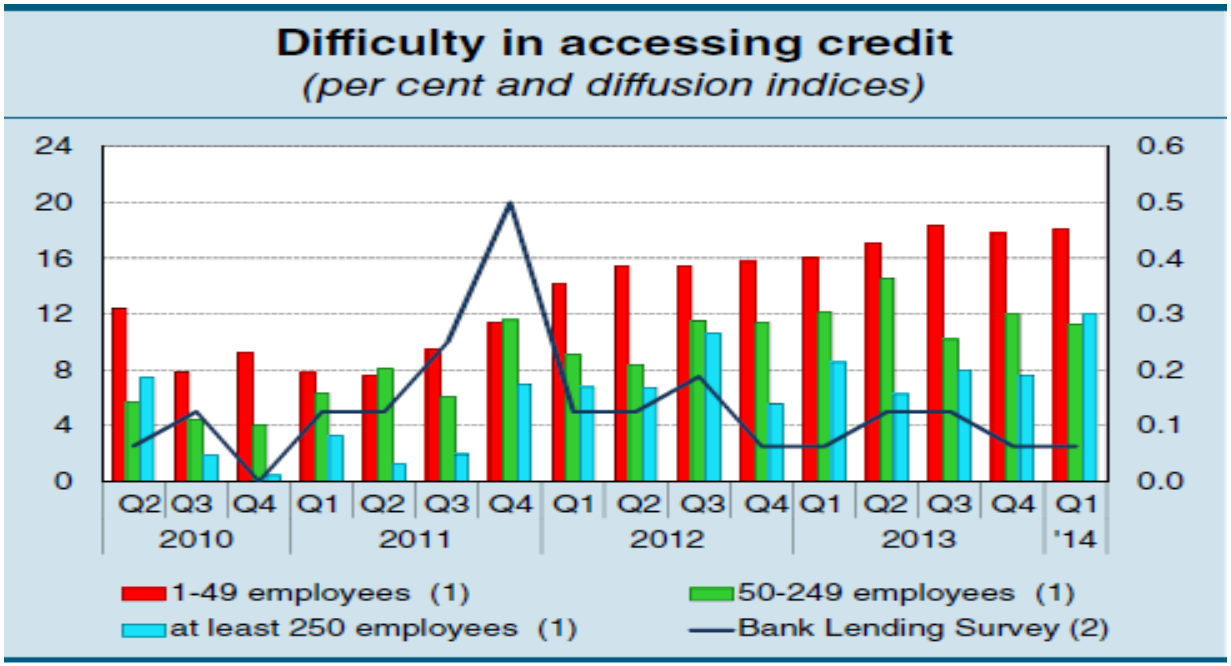
Credit Market Conditions in Italy



Sources: Bank of Italy, Istat and Cerved Group.
(1) Data for companies that filed at least one financial statement in the three years prior to the reference date. – (2) Right-hand scale. – (3) Data for the non-financial corporate sector. The figures for the fourth quarter of 2013 are provisional. – (4) The loans include bad debts. The data refer to a sample of some 420,000 firms, divided according to a score assigned by Cerved on the basis of several balance-sheet indicators. Firms are defined as "sound" with scores of 1 (high safety), 2 (safety), 3 (high solvency) and 4 (solvency); "vulnerable" with scores of 5 (vulnerability) and 6 (high vulnerability); "risky" with scores of 7 (risk), 8 (high risk) and 9 (very high risk) . – (5) The data exclude companies that issued bonds between 2009 and 2013.

Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Credit Market Conditions in Italy

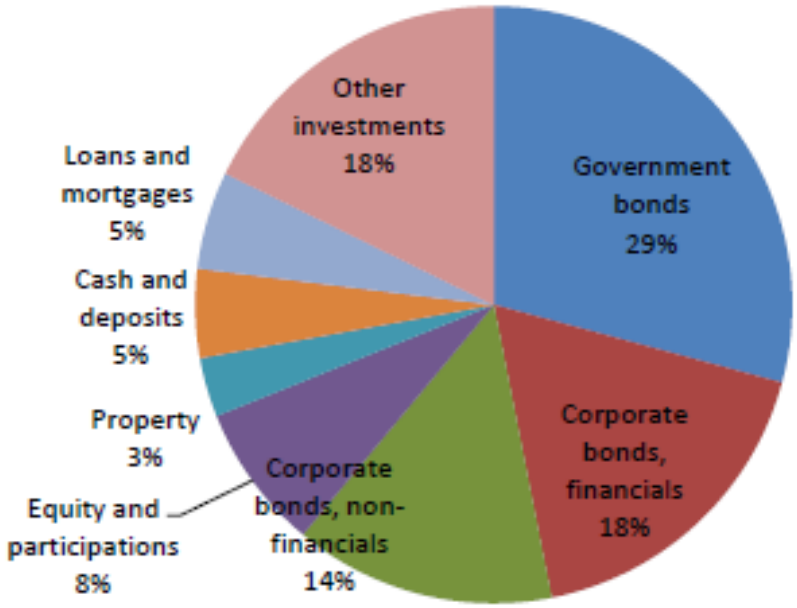


Sources: Bank of Italy and Istat.
(1) Monthly averages; share of manufacturing firms reporting that they had applied for but not obtained credit as a percentage of the total that had contacted banks or finance companies in the last three months. – (2) Right-hand scale. Quarterly data for Italian banks; positive values indicate a tightening of supply. The diffusion indices are built based on the following weighting scheme of the qualitative responses of banks: 1=substantial tightening, 0.5=moderate tightening, 0=basically stable, -0.5=moderate easing, -1=substantial easing.

Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Investment of large European Insurers

Figure 7 Average composition of the investment portfolio of large European insurers at the end of 2013 (4th quarter)



Source: EIOPA (sample based on large insurers in EU and Switzerland)

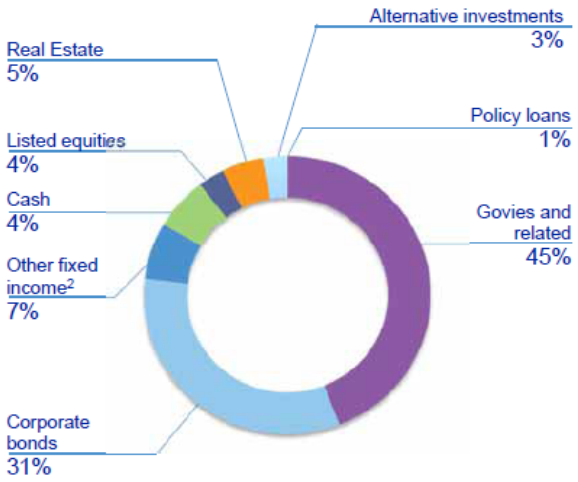
Source: EIOPA, Financial Stability Report, 2014 May

Investment of a large group

Asset Management

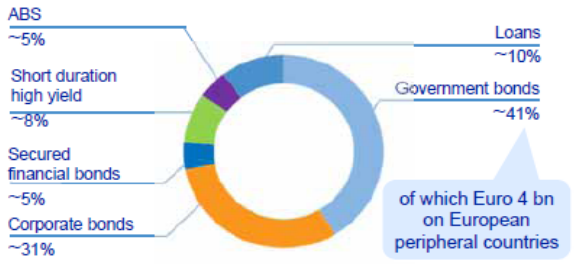
Investment policy in Fixed income for Life & Savings and P&C entities

Investment portfolio overview



FY13 Total insurance invested assets[3]: Euro 470 bn

2013 investment policy on Fixed income



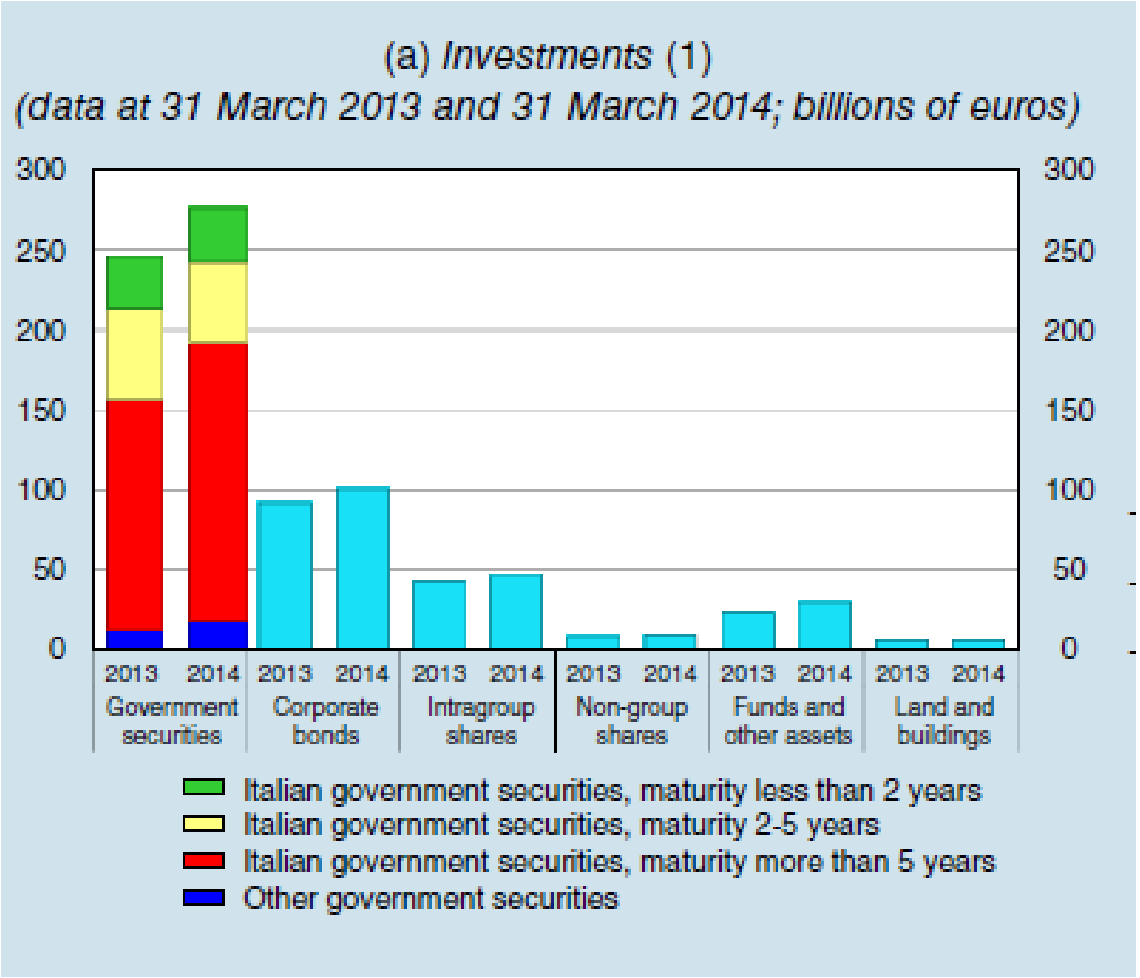
FY13 reinvestment rate on Fixed income assets for Life & Savings and Property & Casualty entities	FY13
Eurozone	3.2%
US	3.3%
Japan	2.2%
Switzerland	1.9%
Total	**2.9%**
Amount reinvested	**Euro 55 billion**

9 - Insurance Europe - Malta, June 12th, 2014

redefining / standards

Source: Improving insurers' investment environment Insurance Laurent Clamagirand, AXA Group CIO
http://www.insuranceeurope.eu/uploads/ModuleXtender/Eventsmanager/109/investmentbreakout.pdf

Investment of Italian Insurance companies



Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Investment of Italian Insurance companies

Assets covering technical reserves
(ratio to technical reserves; per cent and billions of euros)

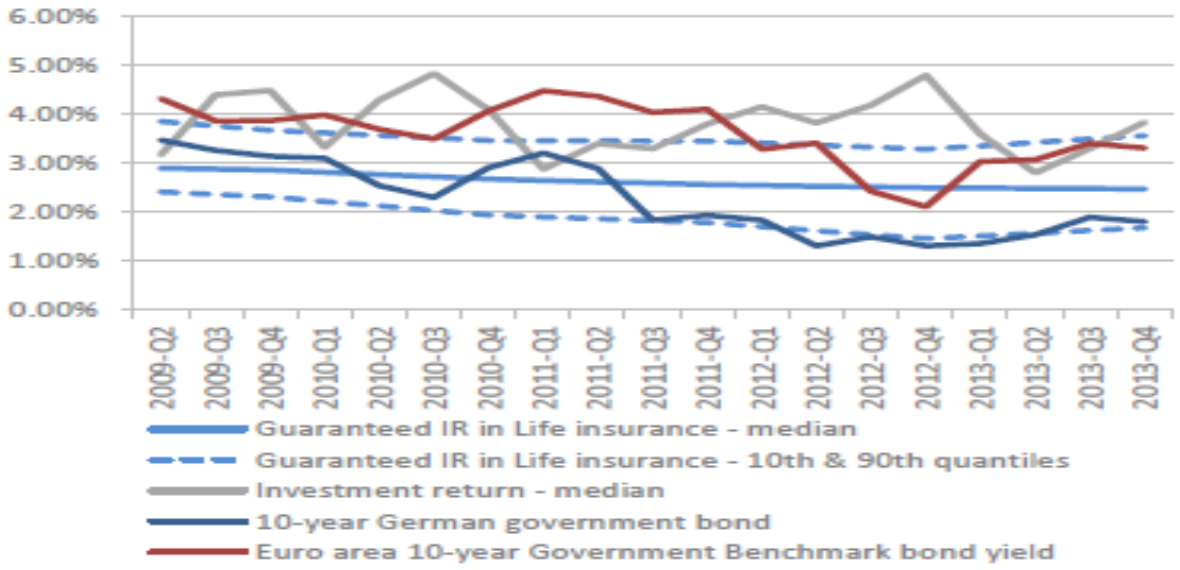
	2011	2012	2013
Debt securities (1)	85.3	85.8	87.7
of which:			
securitizations (2)	*0.5*	*0.5*	*0.4*
securities issued by infrastructure concessionaires (since 2012, 3 per cent ceiling in place) (3)	–	*0.0*	*0.0*
unlisted securities (cap of 10 per cent for total unlisted securities) (4)	*2.2*	*2.6*	*1.5*
Equity securities (5)	5.5	4.6	3.7
of which: unlisted securities (cap of 10 per cent for total unlisted securities)	*1.2*	*1.1*	*0.8*
Real estate (6)	3.9	4.0	3.6
Alternative investments (5 per cent ceiling) (7)	0.4	0.4	0.3
Other assets (8)	5.4	5.9	5.1
Total	**100.5**	**100.7**	**100.4**
Memorandum item:			
Technical reserves (9)	383	395	424

Source: IVASS.
(1) Mostly government securities. Includes units of harmonized bond-based UCITS. – (2) Senior, investment grade securitization issues. – (3) Securities issued pursuant to Legislative Decree 163/2006. – (4) The 10 per cent cap refers to total securities not traded in a regulated market, units of closed-end real-estate funds not traded on regulated markets, units of investment funds reserved to professional investors and units of hedge funds. – (5) Includes units of harmonized equity-based UCITS. – (6) Includes units of closed-end real-estate UCITS established in an EU member state. – (7) Units of open-end non-harmonized UCITS, units of closed-end securities investment funds not traded on regulated markets, funds reserved to professional investors, hedge funds. – (8) Credits (mainly claims on reinsurers, policyholders and brokers and tax credits), sight deposits with banks, and other assets not included in the preceding items. – (9) Total life and non-life technical reserves.

Source: Bank of Italy, Financial Stability Report, Number 1 / 2014 May

Solvency II – The Guaranteed interest rate

Figure 4: Guaranteed interest rate in life insurance vs. investment return, German and Euro area 10Y government bond



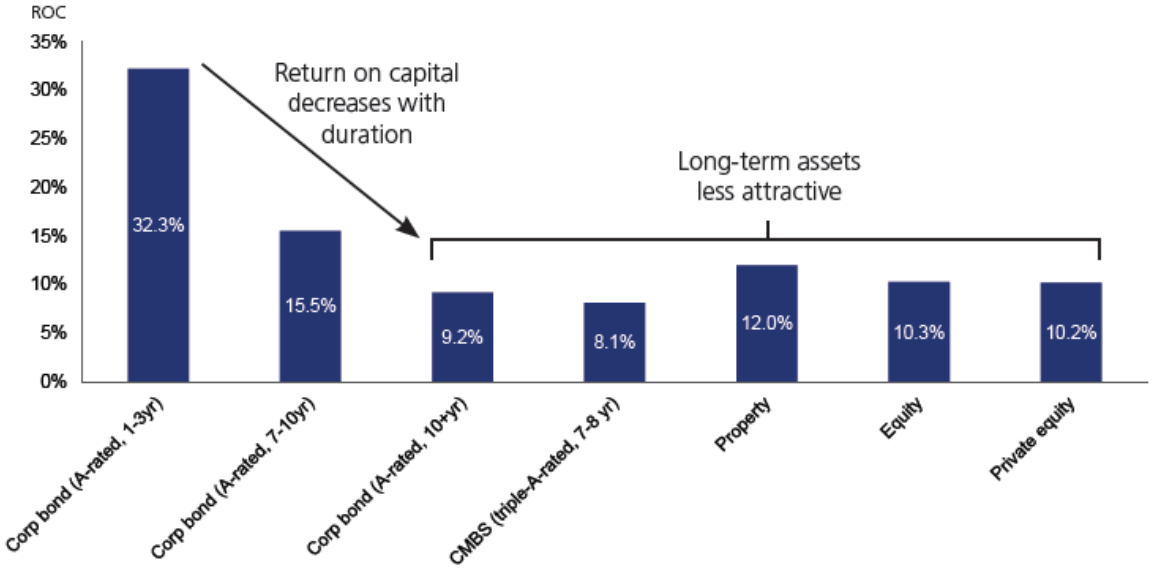
Source: EIOPA (sample based on large insurance groups in EU and Switzerland) and ECB
Note: The figures represent annual guaranteed rates for businesses where such guarantees are applied

In Italy, over 92 per cent of the mathematical provisions relate to policies with guaranteed yields of less than 3 per cent, and new products offer guarantees of less than 2 per cent. (Source: Ivass)

Source: EIOPA, Financial Stability Report, 2014 May

Solvency II

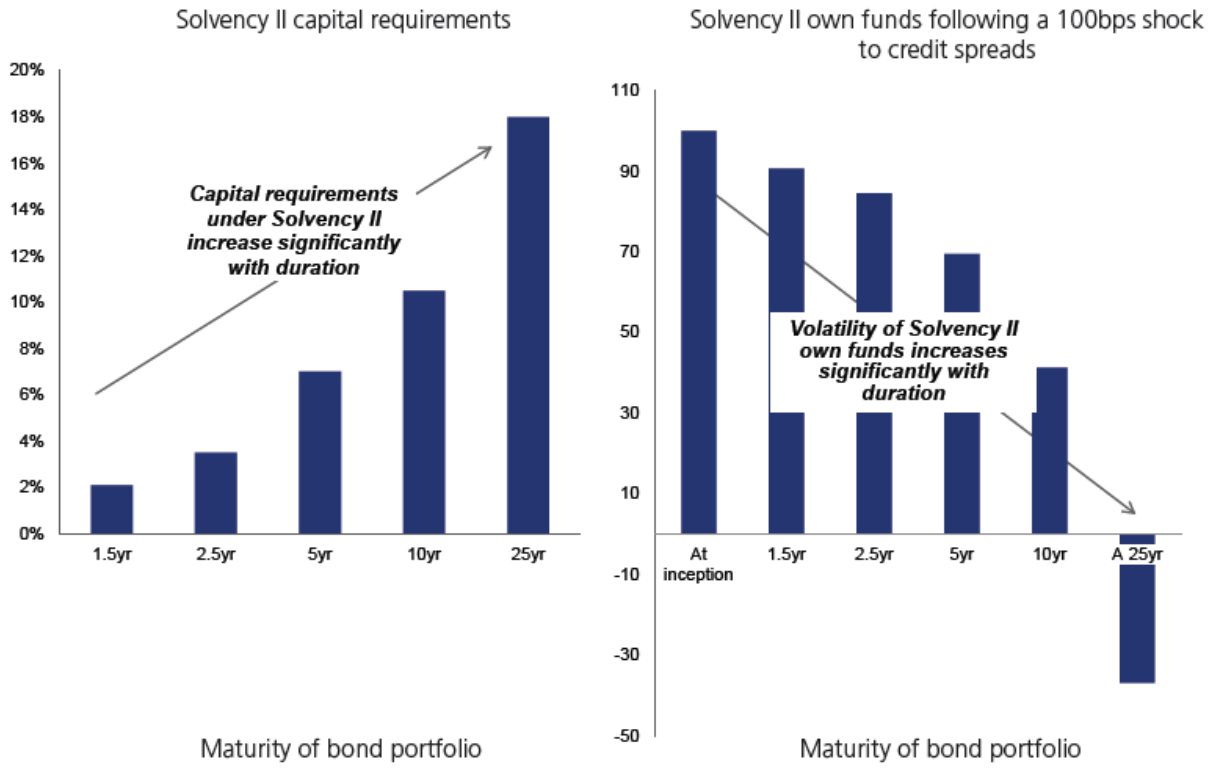
Figure 13: Return on capital (ROC) as a measure of assets' attractiveness



Return over risk-free rate	0.9%	1.3%	1%	2.9%	3%	4%	5%
Solvency II capital	2.8%	8.4%	11%	35%	25%	39%	49%

Notes:
Return on capital is calculated as the expected spread over the relevant risk-free rate (ie, expected yield minus corresponding government bond yield) divided by the Solvency II standard formula solvency capital requirement.
Capital requirement is based on the Solvency II standard formula provided in "Draft implementing measures Solvency II", EC, October 2011, excluding any allowance for diversification
Sources: Bank of America Merrill Lynch government index; MSCI EMU corporate bond index; JP Morgan CMBS index; Morgan Stanley; Oliver Wyman analysis

Solvency II



Notes:
All based on zero-coupon, A-rated corporate bonds
Capital requirements are based on the Solvency II standard formula provided in "Draft implementing measures Solvency II", EC, October 2011
Source: Insurance Europe analysis

Solvency II capital charges and RAROC

A Merrill Lynch analysis

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Asset	Estimated expected excess return	SII Standalone SCR Dec 12	SII Standalone SCR Dec 13	SII Standalone SCR Halved for Type A	SII Standalone SCR Corporate charges for SF	RAROC SII Dec12	RAROC SII Dec13	RAROC SII Halved for Type A	RAROC SII Corporate charges for SF
5y UK Prime RMBS-AAA	47	35,0%	21,5%	10,8%	4,5%	1,8%	2,7%	4,8%	8,5%
5y UK Prime RMBS-BBB	92	80,0%	78,8%	78,8%	22,5%	1,6%	1,6%	1,6%	5,2%
5y CMBS – A	197	76,0%	66,4%	66,4%	4,5%	3,6%	4,1%	4,1%	18,0%
Corp AAA	50	4,6%	4,6%	4,6%	4,6%	9,0%	9,0%	9,0%	9,0%
Corp A 5-7y	64	7,6%	7,6%	7,6%	7,6%	8,3%	8,3%	8,3%	8,3%
Corp BBB 5-7y	103	14,1%	14,1%	14,1%	14,1%	8,5%	8,5%	8,5%	8,5%
Residential Mortgages (75% LTV)	215	3,0%	3,0%	3,0%	3,0%	47,6%	47,6%	47,6%	47,6%
UK prime property commercial loan 4-7y / Germany CRE loan 4-7y	175	16,7%	16,7%	16,7%	16,7%	12,7%	12,7%	12,7%	12,7%
Global equity	850	39,0%	39,0%	39,0%	39,0%	37,0%	37,0%	37,0%	37,0%
Equity other / Hedge Funds	850	49,0%	49,0%	49,0%	49,0%	29,9%	29,9%	29,9%	29,9%

Source: BofA Merrill Lynch Global Research. Reported capital charges refers to the i) proposal as of Dec 2012; ii) update from Dec 2013 for securitisations; iii) alternative considering the effect of halving the standalone capital charges for Type A securitisations; iv) option that assigns the capital charge of corporate bonds to SF bonds (same rating for senior tranches and one rating lower for other tranches).

Strategies

- **Reconsider exposure to unlisted and illiquid assets:** insurers will invest more or less in less liquid assets such as private equity and infrastructure under Solvency II ?
- **Risk transfer:** Insurers may look to transfer their risk to reduce their capital requirements by using reinsurance, securitisation of liabilities, or increased use of derivatives for hedging purposes (BIS, 2011).
- **Minimise duration mismatch between assets and liabilities:** insurers will attempt to minimise the duration mismatch between assets and liabilities (as it drives the capital charges under Solvency II).
- **Enhance diversification:** it can be particularly beneficial for insurance groups and composite insurers.

Source Severinson, C. and J. Yermo (2012), "The Effect of Solvency Regulations and Accounting Standards on Long- Term Investing: Implications for Insurers and Pension Funds", OECD Working Papers on Finance, Insurance and Private Pensions, No. 30, OECD Publishing. http://dx.doi.org/10.1787/5k8xd1nm3d9n-en:

Taxation

- Taxation laws can encourage individuals and investors to adopt a long-term investment philosophy.
- Policymakers can encourage households to invest their long-term savings in the economy via the financial services sector by providing tax incentives on insurance and pension products.
- Tax incentives encourage individuals to plan for retirement, locking their savings in for the long-term. This results in a flow of long-term liabilities to the financial system which insurers can invest in long-term assets, thus helping to fund economic growth.
- The removal/addition of tax incentives associated with investment in insurance products is likely to result in a reduction/increase in the flow of premiums to long-term investments. In taking the decision, it is key to reflect that reduced levels of private savings will eventually also only increase governments' pension liabilities.

Conclusions (1/3)

- Turning back to the initial question, Is (banks') deleveraging a diversification opportunity for insurance companies ?
- Yes, but only accepting a higher risk-return tradeoff (and assuming that the "volatility" and the "matching" adjustment will eventually do their task. BIG IF !). Why ?
  - The opportunity stems from the fact that some "good" demand of credit is not met by banks since the large increase in their capital requirement …
  - … but is very difficult to disentangle between either demand and supply factors or "good" and "bad" demand in the current market conditions (at least, now in Italy)

Conclusions (2/3)

- In practice, the interest rate on BTP 5y is lower that 2%, while firms are willing to pay 5-6% for the same duration (bullet loans). Is this 3-4% enough for compensating for the higher risk ? I think yes but …
  - It is still unclear the effect of the measures announced by ECB, which are exactly aimed at reducing the gap between demand and supply of credit
  - And, in any case, the largest portion of the spread should be paid for increasing the ability to screen and monitor the demand for credit and/or for establishing arrangements able to reduce potential conflict of interests.
- 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
  - the Sovereign Debt Restructuring discussion started by IMF on how to prevent them from being “too little, too late” will become more concrete
  - the debate on eliminating the regulatory bias will reach a conclusion

Conclusions (3/3)

- However, lending on a large scale is a very different business from insurance.
- This explains why it is crucial that a more efficient market for private credit risk is established.
  - The European Central Bank and the Bank of England set out proposals on Friday to resurrect the European Union's market for asset-backed securities and help the flow of credit to smaller businesses.
  - In the short run, central bank input is needed to revive the market (key is what ECB is going to put forward) …
  - while in the longer term it would help stop a repeat of the problems that caused the U.S. market to implode.