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INTERNATIONAL ASSOCIATION OF
INSURANCE SUPERVISORS

Regulatory and supervisory challenges for the Icelandic pension industry

Insurance Core Principle on Investment and its applicability to supervision of pension funds

ICP 15: Investment

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Agenda

- IAIS principle and standards
  - Practical considerations
- Examples of investment requirements
  - Parallels with pension funding issues
- Conclusions

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ICP 15 Investment

The supervisor establishes requirements for solvency purposes on the investment activities of insurers in order to address the risks faced by insurers.

Insurers need to hold sufficient assets to cover technical provisions and regulatory capital requirements

The solvency strength of an insurer depends in part on the quality and characteristics of assets held to meet these requirements

There should be incentives for effective risk management

Supervisors should be open and transparent on the requirements and be explicit about the objectives

Comment: "Liability-Driven Investment" in its ultimate form? This means full funding in a form that reduces (minimises?) the chance of insolvency in future..

Factors to Consider

- Overall quality of risk management and governance
- Valuation basis
- Consistency with requirements on regulatory capital resources
- Adequacy of disclosure requirements to foster market discipline
- Size of net assets
- Availability of assets locally and internationally

Minimum Regulatory Investment Requirements

Security

- Risk of counterparty default or that investment will lose value
- Insurers must conduct own due diligence (CRA Ratings are helpfu, but only as an “extra string to the bow”
- Particular attention to derivatives, use of special purpose entities and securities lending

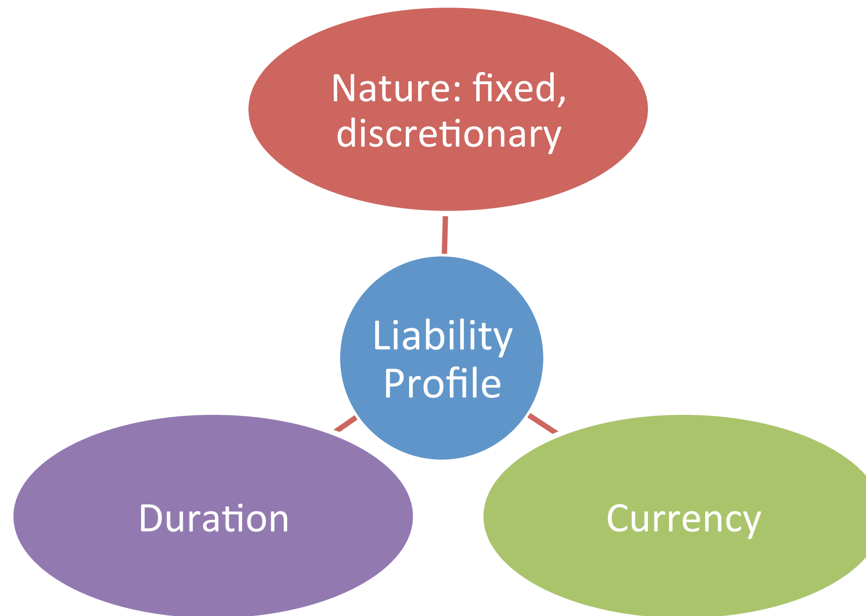
Liquidity

- Ability to meet payments to policyholders and creditors as they fall due
- Liquidity may be impaired if insurer pledges its assets, experience unexpectedly large claim, an event resulting in many claims

Diversification

- Diversification between risk categories – government bond vs. foreign property
- Diversification within risk category – shares of different companies
- Avoid concentration in terms of asset class, geographical location, sector, credit rating

Liability-driven Investments



- Perfect matching is not expected (or possible in most instances) – but need to know extent of mismatch and address gap
- For types of insurance business, even imperfect matching is not possible – ALM is needed (monitoring, transparency and measurement are key aims)
- Close matching is usually expected for unit-linked policies

Risk Assessability

- Insurers should:
  - invest in assets for which risks can be identified, measured and managed
  - be aware of the maximum possible loss in a transaction
  - look through investment structures to understand the underlying assets

Complex and Less Transparent Assets

Special Purpose Entities

- Although legally independent, there might be an implicit obligation of support from the insurer – reputational contagion risk
- Consider prohibition of certain SPEs especially if used to circumvent regulatory requirements.

Structured Credit Products

- Could lose value due to increased correlation between asset classes in times of stress
- Consider quantitative and qualitative requirements to limit investments in such products
- Examples: asset-backed securities, insurance linked securities

Derivatives

- Could produce large liabilities from extreme low-probability market events
- Legitimate use for risk management purposes – hedging
- Consider limiting use for speculative reasons or requirements on suitable counterparties

A recap of ICP 15 standards and their rationale

- 15.1:**The supervisor establishes requirements that are applicable to the investment activities of the insurer.**
- 15.2:**The supervisor is open and transparent as to the regulatory investment requirements that apply and is explicit about the objectives of those requirements.**
- 15.3:**The regulatory investment requirements address at a minimum, the Security; Liquidity; and Diversification; of an insurer's portfolio of investments as a whole.**
- 15.4:**The supervisor requires the insurer to invest in a manner that is appropriate to the nature of its liabilities.**
- 15.5:**The supervisor requires the insurer to invest only in assets whose risks it can properly assess and manage.**
- 15.6:**The supervisor establishes quantitative and qualitative requirements, where appropriate, on the use of more complex and less transparent classes of assets and investment in markets or instruments that are subject to less governance or regulation.**

Types of Investment Requirements

Rules-Based

- Prescriptive rules and restrictions, for example quantitative limits
- Prohibition of investments in certain assets
- Pros: easy to enforce, limited scope for different interpretations, readily explainable in court
- Cons: stifles innovation and opportunities (e.g. foreign investments?), easy to arbitrage, discourages proper risk management, does not fit individual insurer's specificities,
- Example 1: <5% of total assets can be invested in any single counterparty
- Example 2: Assets and liabilities must be matched by geography and type
- Example 3: Strict restrictions on derivative investments

Principles-Based

- Set out high-level objectives and desired outcomes
- Pros: more flexibility for insurer to choose investments that best meet their needs, less need to revise frequently
- Cons: Might be difficult to take enforcement actions, open to different interpretations, more difficult to supervise in general
- Example 1: Invest based on liability profile
- Example 2: Invest to a desired probability of sufficiency of net asset base
- Example 3: Manage through the use of an authorised internal (actuarial?) model.

Conclusions

- At a minimum, investment requirements should address security, liquidity and diversification of assets
- When considering ALM, the potential for matching, by type and term, should have a high priority
- Insurers (and implicitly other bodies with similar “total balance sheets”) should invest in assets based on their liability profile and on their ability to understand and manage the underlying risks of those assets
- More attention should be given to complex, less transparent assets

Thank you for your attention

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