AXA Group

Impact of regulatory changes & other structural issues

ECB - Bond Market Contact Group

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Laurent Clamagirand, AXA Group CIO

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Solvency II may have a significant impact on insurer's investment policy if the framework is not adjusted

- Effective counter-cyclical tools are required under Solvency II to reduce the inappropriate impact of extreme market volatility on insurers and reduce the incentives for pro-cyclical behaviour in extreme conditions.
  - Financial assets are valued at market value and Insurance reserves are valued at the swap rate
    - This generates a disconnection of changes in assets and liabilities and a Volatility in Solvency II Ratio
    - An adjustment of the discount rate for insurance liabilities is necessary to reflect the asset / liability management of companies.
  - Undue volatility should not be reflected in Solvency II ratios
    - Only volatility related to the change in fundamental credit spreads should be reflected in the Solvency II ratio
    - Volatility related to corporate bonds and govies spreads (beyond fundamental credit risk) should not be reflected because companies can hold such assets to maturity and any risk of not being able to achieve this goal is already reflected in the Own Funds and in the Capital Requirement
    - Volatility in Solvency ratios leads the market to ask listed companies to hold an additional capital buffer to cover potential recapitalization
      - Insurers will have to reflect this requirement for an additional buffer in its insurance prices
      - Such situations can lead to forced sales or twisted asset allocations and other systemic behavior to avoid volatility
- Solvency II's current regulatory capital charges should be reviewed. They may dissuade insurance companies from holding certain long-term investments
  - The capital charge will proportional to their maturity and their short-term volatility, leading:
    - On corporate bonds rated A to a capital charge of about 7% and 11% respectively for durations of 5 and 10 years
    - The lowering of the credit rating could lead to a double effect: higher capital requirement and lower capital

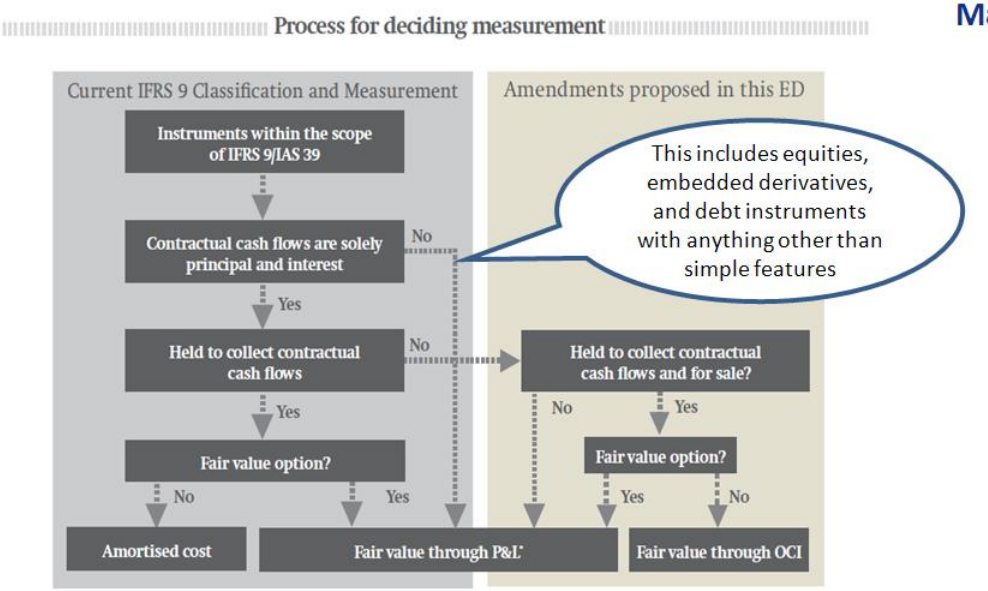
Solvency II : Where we are ?

- **EIOPA issued a Report the 14th of June which introduces a concept of Volatility Balancer to address the issue of undue volatility**
  - **However, the Volatility Balancer methodology contains inconsistencies, the design is flawed and calibrations so onerous as to make it ineffective**

What about EIOPA's proposal?	Why it does not solve the volatility issue?
Design • The volatility Balancer will correspond to a portion of the spreads (net of fundamental credit spreads) of a reference portfolios for the relevant currencies • It will be added to the swap curve used to discount liabilities and the impact would only adjust the own funds, not the capital requirement	▪ The design of the solution is flawed, as being an artificial device only to basic own funds and as, on purpose, not affecting Capital Requirement ▪ This leads to capital requirements not reflecting actual risks because discounted using the swap curve and inconsistent with own funds which include a volatility balancer ▪ For example, if the volatility balancer is not used in the SCR computation, guarantees bite as soon as swap rates move below the guaranteed rates. While actual earned rates will be closer to swap rates plus a portion of observed spreads less fundamental credit spreads ▪ This fails to recognize the fundamental reality of Assets and Liabilities Management (ALM)
Calibration • The Volatility Balancer as proposed by EIOPA only amounts to 20% of the spread of the reference portfolio	▪ Retaining only 20% of the observed corporate bonds and govies spreads fails to remove the volatility affecting assets on a 100% basis ▪ A 75% of the spread could be a suitable calibration to take into account all risks on the liability side but only if the design is adjusted. ▪ Hence, the industry believes a number of substantial changes in the proposals and their calibration are still required to enable the measures to be effective.

IFRS 9 - A deep revision of IAS 39 – a three phase project
Phase 1: Classification and Measurement

- **Effective date for IFRS 9** – As currently proposed, IFRS 9 is effective **for annual periods beginning on or after 1 January 2015**. However, due to new proposals that date is unrealistic – Insurance companies lobby for effective date concurrent with the insurance Project IFRS 4 phase 2 (with earlier application possible)
- **IFRS 9 Phase 1 Classification and measurement of financial assets,** issued in November 2009. Designation of assets according to their nature and business model: **A amortized cost and FV through P&L**
  - Amortized cost & FV OCI limited to only "simple" debt instruments in defined business model (held for collection of cash flows or held for collection of cash flows & for sale)



Main impacts expects for Insurers:

- The collection of cash flow characteristic test is very narrow and will require all but vanilla debt instruments to be at Fair Value through the P&L: (equities, subordinated tranches in structured products, certain pre-payables, compound instruments will require FV through P&L measurement)
- Our view, is that the FV OCI category should be available for all types of assets, including derivatives and real estate that are backing insurance liabilities, to the extent that the later would also have changes recognized through OCI according to IFRS 4 phase 2.
- As such, the proposal may result in financial statements that do not reflect the business model or performance of insurers

➢ **And if the performance reporting is based on a fair value basis, volatility in the income statement will prevent insurers to invest in certain class of assets, notably those with long-term horizon**

IFRS 9 : Phase 2 and Phase 3

- **Phase 2 Expected Credit Losses Switch from an incurred loss model to an expected loss credit deterioration model. The proposed approach segregates the financial asset holding into three stages of deterioration in credit quality since the initial recognition. Re-exposed March 2013**
  - **Stage 1: Assets not affected by observable events**
    - Initially no observable credit events and ongoing whereby the credit quality has not significantly deteriorated as compared to initial recognition
    - Recognition of 12-month expected credit losses – impact is not expected to be dramatic, but results in loss allowance recognition upon purchase or origination → Day one losses
  - **Stage 2: Assets with significant credit quality deterioration**
    - Credit quality has significantly decreased since initial recognition, however no observable credit event
    - Recognition of lifetime expected credit losses
  - **Stage 3: Assets with objective evidence of impairment (Similar to IAS 39 incurred loss triggers)**
    - Recognition of lifetime expected credit losses
  - The proposed model will result in significant increases in the amount of expected credit losses recorded when migrating from stage 1 to stage 2
  - Overall, an earlier recording of impairment charges (stage 1 & 2)
  - Our views on the Re-exposure draft
    - Credit deterioration should be a judgmental process based upon a robust credit risk assessment process
    - The standard should not impose "bright line" thresholds for the transfer from stage 1 to stage 2, such as investment grade to below investment grade triggers, which could result in an inappropriate levels of provisions and undue volatility
    - Substantial changes to internal processes and systems will be required
  - FASB (US GAAP) has proposed a single model that recognises lifetime expected credit losses for ALL – at inception and each reporting date.
- **Phase 3 Hedge accounting,** Objective of "simplifying" existing principles. **Near final review published September 2012**
  - First stage addresses the general hedge accounting model
  - The macro or portfolio hedge accounting model is being addressed separately, which could be of big interest for insurers

EMIR: Implications for Bond Strategies

- EMIR enters progressively in force, following the Dodd Frank regulation in US
  - Reporting obligation – need of resources and operational setup in the context where there is no candidate for trade repository in Europe at this stage. The target date is in November 2013
  - Interest rates swaps and part of CDS will be the first cleared instruments starting in 2014

- The new regulation introduces a set of rules that will have a major impact on the derivatives market
  - Initial margin obligation – financial institutions need to post high quality assets to meet the initial margin requirements, increasing the pressure on these eligible assets
  - Variation margin obligation – the clearing houses do not accept securities as collateral. This is very problematic for the investment funds for which the purpose is not to hold cash

- For bonds strategies, the interest rates swaps, CDS and FX represent the most common instruments for hedging, the first two being in the first line for clearing. Still pending decision for FX instrument having big implications for the industry

➢ The variation margin in cash is a major issue for hedging the risks in the funds (i.e. FX risk from foreign bonds) in the context where there is a proposal from ESMA not to allow cash coming from repo for collateral.

Securitization market

- Limited issuance volume since 2007 crisis
- No significant involvement of final investors such as insurance companies in this market
- Leading Central Banks to step in to provide direct secured funding to banks against AXA: retained ABSs used as repo collateral by banks to get ECB funding.

- Clear willingness of regulators and politician to reinforce the role of securitization and encourage investors to increase their involvement:
  - To promote the use of securitization technics: Recent announcements from the ECB
  - To ensure risk and funding transfer from banks to institutional
  - To tackle current credit crunch with a specific focus on SMEs loans

- In the meantime, launch of several private initiative to improve transparency of this market:
  - PCS initiative
  - …

➢ However may hurdle remain for final investors to re-open the asset class in their allocation:
  - current S2 capital charges
  - EIOPA calibrates all ABS asset classes using data of the worst performing sub-segments like US subprime RMBS without differentiating between the high quality sectors and the other ones.
  - Unclear retention rules
  - No clear market making rules / framework

PSI

- Since the onset of the Eurozone Sovereign Debt Crisis, **country bail out packages** by the Troika have sometimes encompassed investor losses.

- **Investors involvement** took place on an ad-hoc basis
  - An PSI in Greece
  - Hair cut on deposits in Cyprus

- There are currently **no clear guideline on investors losses** in the context of a bail-out package which triggers uncertainty.

- The International Monetary Fund, following the publication of a much publicized paper is reviewing its approach of **sovereign debt renegotiation/default**.
  The IMF work on the issue should be **completed over the next two years**.
  - The recent implementation of Collective Action Clause should impact sovereign debt renegotiation.

➢ Given the current uncertainty, **AXA Group invests in sovereign debt selectively**, focusing on the overall credit quality and the debt sustainability of sovereign issuers.

Investing in Bank Debt

- **Bank debt remains the main asset class for IG credit investors**
  - 60% of IG debt stock in Europe
  - 30% in the US
- **In the LT current regulatory reforms should make the sector fundamentally safer**
  - lower probability of default (PD)
  - but also lower recoveries (bail-in / depositor preference / asset encumbrance)
- **In the ST → uncertainty** on PDs/recoveries and on the application of new regimes
  - Dodd Frank Act (Orderly Liquidation Authority) – opco "creditor preference" but debt sits mostly at holdco
  - Europe – learning as we go through real-life precedents
- **Are investors compensated for uncertainty ?**

  Market technicals (low supply, search for yield) drive bank spreads down

➢ **Investor's approach → higher selectivity of names**

Concentrating on names with stronger fundamentals and hence lower PD and possibly going lower in the capital structure