Institute and Faculty of Actuaries

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

4 April 2014

Dear Sir/ Madam

Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

The Institute and Faculty of Actuaries (IFoA) welcomed the publication of the FSB's Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (NBNI G-SIFIs).

Summary

We want to support the FSB in developing its approach and have identified a potential risk for derivative markets within the proposed 'Asset liquidation/Market channel' that, whilst not directly covered in the consultation questions, could arise through the interface between NBNI G-SIFIs and the insurance industry and, thus, have implications for the FSB's work in this area.

A new area of risk that could affect the financial industry, on a systematic basis, arises from the combination of a move towards using a swaps based discount curve for Solvency II, at the same time as we move to using central clearing for derivatives. Specifically, this shift may lead to derivative markets freezing in response to potential liquidity constraints following from requirements to post collateral in specified forms within the swap market.

Rationale

The move towards using a swap based discount rate, rather than government bonds, means insurance firms have to make a decision on whether to change their investment strategy accordingly - to use swaps, rather than government bonds - to achieve their duration and better match their assets to liabilities. This could lead to a significant change in the assets insurers hold, with more swaps and less direct holdings of assets, such as bonds, in future.

An immediate consequence of changes to an insurer's investment strategy is that swaps require collateral to be posted on market movements and, as they are centrally cleared, this needs to be in the form of cash or government bonds. Firms that have moved out of government bonds into swaps, to better match the discount rate, will have heavily constrained their available capacity to post collateral. If we see significant market movements, then there is a potential risk that firms will be unable to secure the collateral they need to post and, as a result, breach their collateral requirements. This would have consequences for banks that have issued the swaps and, depending on the scale of interest rate moves, could cause substantial disruption to the derivatives markets.

When collateral needs to be posted as cash, a further risk may arise if customers seek to use repo facilities to convert their government bonds. This may increase the leverage ratio for banks and heightens the risk that repo facilities would be unavailable at times of market stress (thus preventing companies from using their government bonds as collateral). Market conditions would be depressed further if banks responded by raising cash through selling government bonds – and, if those government bonds are currently backing liabilities, this would potentially introduce mis-match risk into the balance sheet.

This response has been drafted by the IFoA's Recovery and Resolution Working Party, whose members have substantial experience of, and expertise in, the insurance industry. Should you want to discuss any of the points raised please contact Paul Shelley, IFoA Policy Manager (paul.shelley@actuaries.org.uk/ 07917604985) in the first instance.

Yours sincerely,

David Hare
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