FERMA
RISK MANAGEMENT
SEMINAR 2012

Panel Debate 5:
The Role of Financial Institutions in the Current Economic Climate

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Current Macro Economic Climate

Ernst & Young Eurozone Forecast
Autumn Edition – September 2012

Ernst & Young
Quality In Everything We Do

Key issues

Some steps have been taken by policy-makers to ease the strains on the economy, but we predict a **rough road ahead** and a difficult second half for 2012.

► **Uncertainty continues** – we have not yet seen the market stability we all desire.

► Live with **greater volatility** in the global economy.

► **Stagnant growth rates** - GDP fell 0.2% in Q2 and we forecast a contraction of 0.5% in 2012.

► **Unemployment rising** until 2014 throughout the Eurozone and this will continue to constraining consumer spending.

► **Companies remain cautious** and corporate investment to remain below its pre-crisis peak until 2016.

Key issues

- **Rapid-growth economies slow down**
- **A renew credit crunch remains possible –** banks continue to tighten leading criteria
- Operating in a **fragmented Eurozone** – managing risks arsing from mismatches between borrowings and assets is an urgent priority

Eurozone forecast September 2012

Table 1

Forecast of the Eurozone economy (annual percentage changes unless specified)

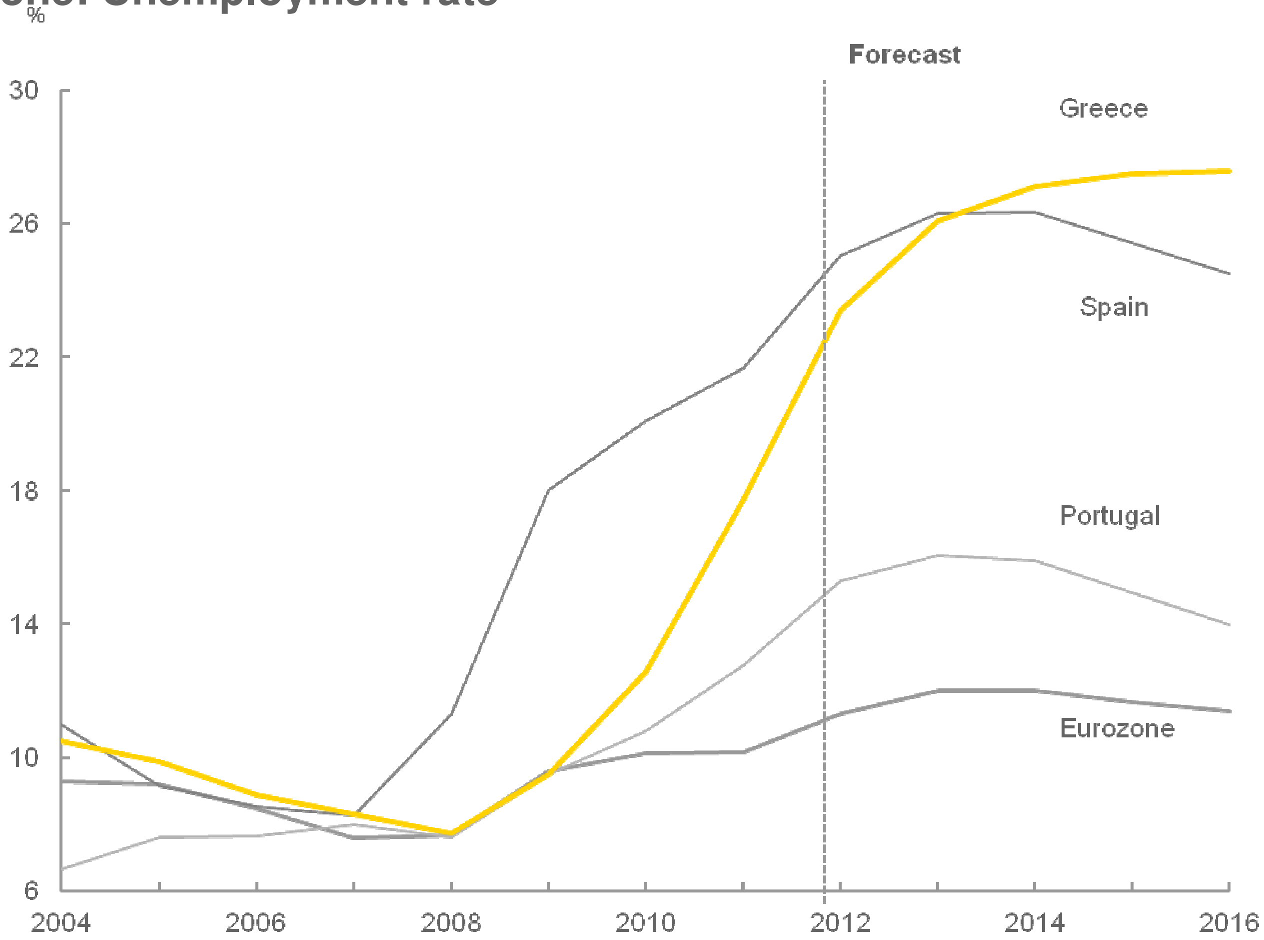
Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	1.5	-0.5	0.1	1.1	1.3	1.4
Private consumption	0.1	-0.8	-0.1	0.7	1.0	1.2
Fixed investment	1.6	-3.1	-0.2	2.3	2.7	2.6
Stockbuilding (% of GDP)	0.4	-0.3	-0.5	-0.4	-0.4	-0.5
Government consumption	-0.1	0.0	-0.7	-0.1	0.4	0.7
Exports of goods and services	6.3	2.7	3.0	4.7	4.7	4.4
Imports of goods and services	4.1	-0.4	2.2	4.5	4.8	4.4
Consumer prices	2.7	2.3	1.7	1.4	1.3	1.3
Unemployment rate (level)	10.2	11.3	12.0	12.0	11.7	11.4
Current account balance (% of GDP)	0.0	0.8	1.1	1.0	0.9	0.9
Government budget (% of GDP)	-4.1	-3.4	-2.5	-1.9	-1.4	-1.0
Government debt (% of GDP)	88.0	91.1	93.1	94.0	94.7	94.6
ECB main refinancing rate (%)	1.2	0.9	0.8	0.8	0.8	0.8
Euro effective exchange rate (1995 = 100)*	120.8	115.0	114.0	110.0	106.4	107.2
Exchange rate ($ per €)	1.39	1.27	1.24	1.17	1.12	1.13

* A rise in the effective exchange rate index corresponds to an appreciation of the euro

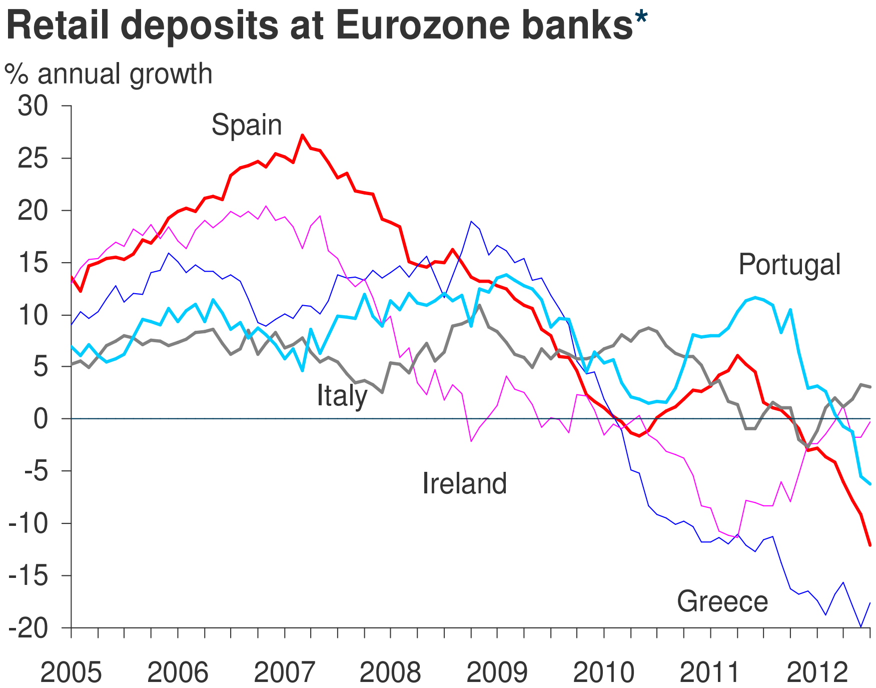
Necessary reforms for growth and stability in the Eurozone include employment

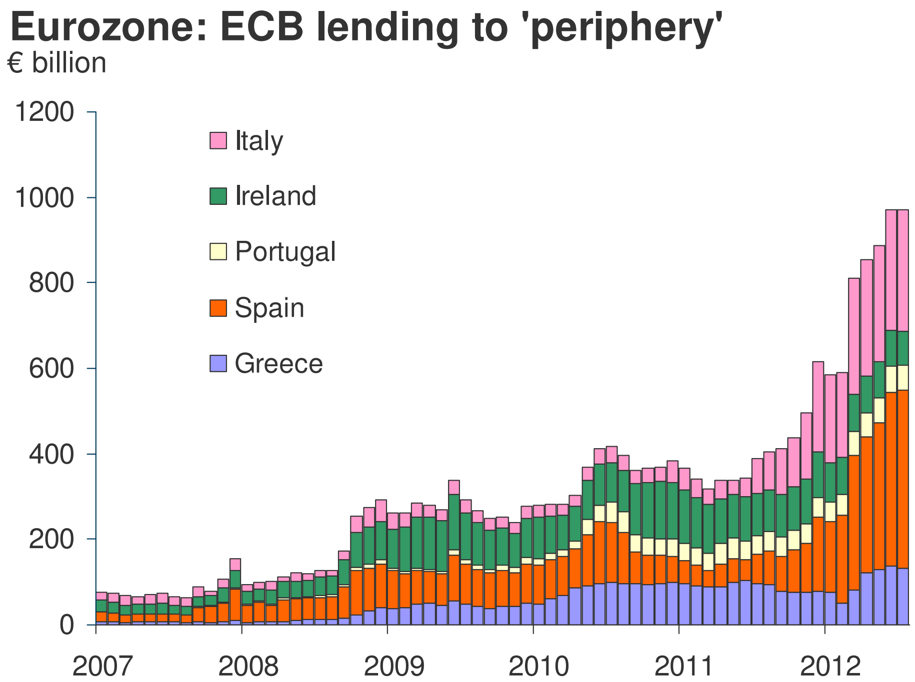
Eurozone: Unemployment rate



Source: Oxford Economics

ECB support for banks in place, but still weak lending and risk of a domestic banking crisis





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Sizing the impact – questions for businesses active in the Eurozone

- The banks have been subject to stress tests, how would your business perform under similar tests?
- Are you capable of withstanding the fallout of a major shock to the financial system?
- Have you analyzed the impact of likely changes to the financial sector on your financial strategy?
- Is your business model fit for purpose for a significant period of below-trend economic growth?
- Could your operations cope with an emergency denomination of a currency?
- Is there a plan in place to manage additional economic and financial risk?
- Have you identified the opportunities that may emerge in this volatile environment?
- Does your company have a stakeholder communications plan to address these questions?

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Role of the Financial Institutions in the Current Economic Climate

Banks

PROMONTORY

P-Y THORAVAL

After the crisis?

- ***The economic climate has changed dramatically and even if the impact of the crisis and the subsequent regulatory reforms are still difficult to measure, it should have some impact.***

1) **the current economic climate has changed**

- **The crisis is not finished, but …**
- the psychological aspects are obvious: the dramatic crisis has **damaged** the banking sector image :
- the general public, Main street, has some difficulties understanding why the banking sector should absorb billions of public money, whereas the banking conditions to borrow money are tougher. This can be explained by some of the regulations that are planned.
- - the regulatory environment is **tougher** after the crisis : Basel III (capital and liquidity rules), Solvency II, Dodd Franck Act, Volcker, Vickers, Liikanen: all these rules decrease the profitability and increase the costs of the financial system but **aims at reducing the systemic risk.**

2) **The role of the financial Institutions is not supposed to change a lot but to return to basics:** financing the Economy and the growth remains the aim. However, the regulatory constraints are likely to have some impact.

- So far, the new rules, not yet fully in place, have little impact: if the Tier 1 ratio is increasing, the distribution of credit remain positive and the cost of risk (except in some area such as Greece) remain relatively low. The BIS studies indicate **so far** a very limited impact.

What will change?

- The economic climate per se, indeed, remains difficult: the crisis –which is global and structural- lasts and is likely to last, as the remedies used are similar to the one applied at the beginning of 1929 and produce a reduction of the Effective Demand nearly everywhere in the world. (G – T) is lowering under strict budget constraints. As a result, consumption, investment, international trade and growth is low. This is true in Europe but also in the USA, Japan and even China. However there are some good news, even in Europe (EMS, Banking Union).

- The key question is : how the financial sector can continue to provide funding to the economy when so severely hit by the financial repression (increase in their funding cost) and without slowing too much the adjustment on the demand side (to avoid depression circle) = a delicate balance to strike .

- the regulatory environment is "vibrant", in revolution, and tougher after the crisis : Basel III (capital and liquidity rules), Solvency II, Dodd Franck Act, Vickers, Liikanen, Tobin tax: all these rules decrease the profitability and increase the costs of the financial system. These rules however, by deleveraging, aim at **reducing the systemic risk**, sometimes imposing a ring fencing; but they are not coordinated , each zone willing to impose its solution. Applying at the same time Volcker for a part, Vickers, and Liikanen could be rather difficult.

What will really change?

- **1) Sovereign risk and Real estate** are again seen as risky. Return to normality!

- **2) Proprietary trading and Investment banking will reduce** everywhere, but especially in Europe, where banks have already undergone a drastic reduction of the Risk weighted Assets as well as reduction of their short term USD liquidity needs (e.g. needs -55% for one of the top French bank). The staff in these sectors have also been reduced dramatically; other factors can also have a role, such as FATCA, pushing some EU banks to move out of the USA. Will it have an impact on the market risk?

- **3) The SME and *C* & I, the munis** and some sovereigns claim to have more difficulty to get financing. The blame is sometimes put on the new regulations or on rating agencies, but it is due mostly to the economic conditions.

- **4)** The new environment could push banks to transmit some of their credit portfolios **to insurances** and probably move some assets under the **shadow banking.** If so, the global risk will not be too much reduced but transferred.

What will really change?

→ It remains to be seen if those regulations will be adopted, or, if so, what will be the effective application (for instance what is the applicable definition of "proprietary trading" ?).

→ For banks it is a challenge that has to be though **as an opportunity** to increase compliance and efficiency by trying to turn regulatory constraints into a strategic approach.

FERMA 2012
Panel Debate 5
The Role of Financial Institutions in the Current Economic Climate

Gérald Harlin, AXA Group CFO

Versailles, October 23, 2012

redefining / standards

Agenda: Role of Financial Institutions in the Current Economic Climate

1. **A new risk based regulation for insurance**

2. **Role of insurers to finance the economy over the long-term**

1. A new risk based regulation for insurance

- What does Solvency II mean for insurance companies ?
  - Market-consistent value of the assets and fair value of the liabilities
  - EU consistency in the risk-based capital adequacy relative to economic risk
  - Common implementation
  - Close regulatory and supervisory monitoring and dialogue
- What will Solvency II regulation bring ?
  - Holistic and economic risk approach
  - Improve the risk management culture in all companies
  - Avoid mismatch between assets and liabilities through better Asset Liability Management's strategies
  - Mark-to-market approach of the balance sheet
  - Foster better governance in all entities
  - Enhanced transparency for the policyholder, the investors, the supervisors and the market

1. A new risk based regulation for insurance

- Without corrective actions and in particular effective counter-cyclical tools the regulation could:
  - Reduce the long term investment capacities of the Insurers with detrimental impacts on the global economy
  - Create pro-cyclicality impacting the stability of the Financial System (forced asset sales)
  - Transfer risk from the Insurers to the Policyholders
  - Induce higher costs or less comprehensive products
- The final Solvency II negotiations are crucial:
  - Ex-ante Impact assessment of the counter-cyclical tools (with the full industry package and a realistic timeline) to better calibrate the Framework
  - Full equivalence
  - Entry into force on January 1st 2015 ? 2016 ?
- If correctly calibrated, Solvency II capital charges could e.g. foster long-term financing assets (European Commission letter to EIOPA)

2. Role of insurers to finance the economy over the long-term

- Banks aims at deleveraging their balance sheets:
  - Evolution of regulatory framework (Basel 3 and new liquidity requirements) forces Bank industry to:
    - reduce their origination activity
    - consider desintermediation processes
  - Reduction of banks' appetite for medium and long term financing driven more by capital requirement constraint rather than risk management
- There is willingness from corporate to diversify their source of funding in a context of potential credit crunch and significant increase of financial market volatility

2. Role of insurers to finance the economy over the long-term

- Insurers have opportunity to act as a responsible financial partner for the real economy:
  - by providing financing to key sectors to real economy at a country level (Small and medium size entreprise)
  - but also more globally at an international level (financing to sector such as infrastructure,…)
- Partnering with banks will offer insurers with investment opportunities
- Solvency II might encourage such financing:
  - European Commission asked EIOPA to come up with refinments on Solvency II capital requirements on long-term financing assets

    (e.g. Infrastructure, SME financing and socially responsible investments; securitization serving those purposes)