

## Insurance Europe key messages on IAIS consultation on higher loss absorbency (HLA) requirements for global systemically important insurers (G-SIIs)

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### Insurance Europe's key messages on the IAIS's HLA consultation

Insurance Europe welcomes the possibility to comment on the IAIS's consultation document on higher loss absorbency (HLA) for global systemically important insurers (G-SIIs). Insurance Europe believes that a number of improvements and clarifications are needed as part of the HLA development.

#### The focus of the HLA should be on activities that give rise to systemic risk.

- This would be in line with the Financial Stability Board (FSB) mandate: "The policy measures that will apply to G-SIIs are consistent with the policy framework published by the FSB in November 2011. They include for each G-SII: [...] iii) Higher loss absorbency requirements (HLA) for non-traditional and noninsurance activities."<sup>1</sup> It is also supported by the IAIS's own conclusion in the report "Insurance and Financial Stability"<sup>2</sup>, which states that there is little evidence of traditional insurance generating or amplifying systemic risk within the financial system.
- The widened scope of the HLA, beyond NTNI activities, is of particular concern. The current consultation document refers to the possibility of traditional insurance business causing the distress or failure of a G-SII. This suggests that the IAIS is trying to differentiate between a G-SII's distress or failure and the transmission of systemic risk. However, where possible distress and failure are already addressed by the group PCR, the HLA should focus on the transmission of systemic risk.
- A sensible HLA should both reward a decrease in and disincentivise growth in systemically risky activities. This aim would not be achieved if the scope of the HLA were extended to traditional insurance business. The comparison between G-SIIs and G-SIBs (as illustrated in Annex F paragraphs 4 and 5) appears as a way to circumvent the fundamental challenge of a calibration of the HLA requirement. While Insurance Europe understands that the issue of designation is a separate workstream that will be discussed later this year, it would strongly argue that an activity-oriented

<sup>1</sup> FSB, "Global systemically important insurers (G-SIIs) and the policy measures that will apply to them" ([link](#)), 18 July 2013, paragraph 4

<sup>2</sup> Published in November 2011 (available [here](#)), see eg paragraph 9 of the document

approach would be far more sensible than an approach aimed at designating a few organisations that would apply specific prudential measures.

**The proposed calibration target for the HLA requirement is too high and fails to adequately acknowledge the differences between G-SIBs and G-SIIs.**

- The calibration target should be relative to the level of systemically risky activities undertaken.
- Given the nature of their core business model, G-SIBs pose a far greater risk to global financial stability than G-SIIs. In fact, the use of bucketing for G-SIBs acknowledges that the charges need to be proportionate to the level of systemic risk posed by institutions.
- The amount of NTNI business of a G-SII must be taken into account appropriately, depending on the calibration target for the HLA. For G-SIBs in the lowest banking bucket, the HLA increases the capital requirement by 12.5% (as explained in Annex F, paragraph 4 of the consultation). However as determined in the 2014 field test, on average the value of a G-SII's BCR NTNI, which measures the level of systemically risky activities, amounts only to about 20% of the full BCR. Thus, only 20% of the lowest G-SIB HLA charge should apply in the case of a G-SII, ie a calibration target of  $20\% \times 12.5\% = 2.5\%$  for the lowest bucket.
- Therefore, any potential HLA for G-SIIs should be calibrated at a materially lower level than the smallest capital requirement increase applied to G-SIBs.

**The BCR+HLA framework should not give rise to an unlevel playing field with other regulated sectors.**

- For other regulated sectors, the insurance HLA should not apply unless those activities would separately qualify for HLA under the respective sector's systemic regulation.
- For example, applying HLA to asset management businesses owned by G-SIIs will create a competitive distortion between them and other asset managers who are not owned by G-SIIs. This would also be an ineffective measure, as such activities would likely migrate to non-regulated entities. The debate concerning whether asset managers should be designated as G-SIFIs has yet to be resolved, with the current focus being devoted to activity-based measures rather than entity-based measures. Any potential HLA charge for asset managers should be determined following the conclusion of the FSB/IOSCO work and the outcome of this should not be prejudged by the IAIS's approach to G-SIIs.
- Regulated banking activities conducted by a G-SII should be charged according to Basel III including bank-specific HLA rules. No HLA should be charged unless the banking activity itself is deemed a G-SIB.

**An assessment of the impact of the HLA framework is difficult given the related policy areas that are still subject to change or clarification. The fundamental design of the HLA should be reviewed once the other policy aspects on designation methodology and NTNI are completed.**

- Factors relevant to the design of the HLA are being reviewed, in particular the designation methodology for G-SIIs and the identification of NTNI activities.
- There is a need to address the perceived transmission mechanisms for systemic risk in insurance and the role of capital in this regard.
- Insurance Europe would have preferred the possibility of commenting on the design of the HLA after the reviews were completed. It is difficult to fully assess the potential impact of the proposed measures at this time.
- Insurance Europe acknowledges that the IAIS intends to fine tune the HLA over the confidential reporting period. Insurance Europe, however, proposes that the IAIS agrees to review the fundamental design of the HLA once the other policy aspects on designation methodology and NTNI are completed.
- Insurance Europe also has strong reservations over the rationale for an approach that designates entities rather than activities as having the potential to create systemic risk in insurance.

**Insurance Europe is concerned by the inappropriate link between size and level of HLA penalty.**

- As the current scoring methodology is implicitly based on size, different buckets would only represent different sizes of G-SIIs and would impose higher HLA requirements on larger groups, rather than penalising those with more systemically risky business. Insurance Europe notes that, in its analysis, the IAIS should give appropriate consideration to the fact that size may often be beneficial, as it gives rise to more diversification benefits.
- The designation methodology is also based on positions relative to other insurers and this can potentially create inappropriate incentives. For example, if all insurers reduced their systemically risky activities proportionately, there would not be any impact on the insurers' scores and the buckets to which they are allocated.
- In light of the ongoing policy developments on designation and identification of NTNI, Insurance Europe notes that it is questionable whether a reasonable decision on the number of buckets can be made. If the IAIS proceeds under the current schedule, then the number of buckets should be reviewed once the scoring methodology is able to reflect the systemic riskiness of an insurance entity.

**Due to its design and lack of risk-sensitivity, the BCR is a very volatile basis for the HLA. This makes the full framework BCR+HLA volatile and is very likely to provide inadequate and conflicting risk management incentives. In consequence, the BCR/HLA framework might cause systemic risk instead of reducing it.**

- The proposed uplift to the BCR will amplify its inherent design weaknesses as it was designed as a risk-insensitive and factor-based measure that does not explicitly reflect diversification and asset liability management and was accordingly calibrated at a low level.
- The proposed uplift of BCR + HLA, as an additional measure to the PCR, will pose a significant challenge to businesses, as they would need to manage two different capital measures that are likely to react in different ways in different market conditions. The BCR+HLA should therefore not be binding and supervisors should be able to apply forbearance in appropriate circumstances.
- Moreover, the methods for valuation and determining capital resources for the HLA are the same as for the BCR, which implies that the HLA suffers from the same weaknesses as the BCR in terms of key elements of design and measurement, including valuation of the balance sheet, determination of required capital and definition of capital resources.

**If a BCR uplift is introduced, then a transitional measure intended for the BCR uplift is supported and other transitional measures should also be considered.**

- Additional transitionals should be considered, for example in the area of capital resources. It must be ensured that no item of high-quality capital resources, recognised as such under local requirements, suddenly becomes inadmissible for meeting capital requirements when the HLA is introduced. The envisaged qualification requirements for core capital should therefore be phased in.

**The IAIS should assess the proposal for the BCR/HLA under a range of scenarios in order to test whether the proposal works under circumstances that are different from the current ones.**

- For example, the 33% increase for the BCR uplift is calibrated based on a single point in time, ie 2014 data. This does not seem a reasonable approach for a calibration of that relevance.

**It is very important that the HLA is designed and tested in a comparable manner across the globe.**