INIA submission to the IAIS on its proposed methodology for identifying systemically risky insurers (31 July, 2012)

I. Introduction

1. The Canadian Life and Health Insurance Association (CLHIA), in its role as Secretariat of the International Network of Insurance Associations (INIA), is pleased to submit these joint comments on behalf of the following life and health and property and casualty insurance and reinsurance associations: American Council of Life Insurers (ACLI), American Insurance Association (AIA), Association of Bermuda Insurers and Reinsurers (ABIR), Association of British Insurers (ABI), Canadian Life and Health Insurance Association (CLHIA), German Insurance Association (GDV), Insurance Council of Australia (ICA), Insurance Europe, Reinsurance Association of America (RAA) and the South African Insurance Association (SAIA). The aforementioned INIA members, who together represent over 70 per cent of the world's insurance business, would like to submit their comments in response to the consultation on the assessment methodology to identify global systemically important insurers (G-SIIs). We also note that our organisations, individually or jointly, may be providing additional or more detailed comments.

2. INIA recognises that all financial sectors including insurance should be assessed for the potential systemic risks they pose in order to ensure the development of a stable and sustainable international financial system. In this regard, INIA welcomes the work conducted by the IAIS in this area in recent years and appreciates the opportunity given to comment on the draft methodology.

3. INIA appreciates the IAIS's recognition, first in its November 2011 report "Insurance and Financial Stability" and again in the introduction to the consultation that there is little evidence of traditional insurance either generating or amplifying systemic risk within the financial system or the real economy. We strongly support the IAIS's conclusion that only certain non-traditional and non-insurance activities if uncontrolled have the potential to generate systemic risk in insurance. Moreover we subscribe to the conclusion that not every non-traditional or non-insurance activity should be considered as a potential source of systemic risk. An example here would be the designation of third party asset management as a non-insurance activity, which is acknowledged by the IAIS in paragraph 17 as not being a source of systemic risk.

4. We also appreciate the IAIS' recognition that simple replication of the indicator-based approach as applied by the Basel Committee on Banking Supervision does not work for insurers. Unfortunately the proposed methodology still does not reflect sufficiently the significant differences between the two sectors in terms of business models. In our view, in insurance, the focus of the indicator based approach should be on the specific activities that have the potential to generate systemic risk.

5. We therefore regret that the proposed indicator based approach incorporates a number of categories (e.g. size, global activity) and indicators (e.g. reinsurance, intra financial assets) not necessarily related to systemic risk in insurance. In addition we are concerned that the proposed definition of NTNIA is unnecessarily broad and that NTNIA activities that are not systemically risky are included as indicators in the IAIS methodology. We would suggest that the IAIS methodology should incorporate a narrower and more precise list of indicators relating to potentially systemically risky NTNIA otherwise insurers may be incentivised to exit/cease legitimate business activities to avoid being determined as systemically risky. Subject to a refinement of the indicators of potentially systemically risky NTNIA, INIA believes that the focus of the proposed methodology should be on capturing the part of insurer activities which are included in this category.

6. Having in mind the specific nature of the insurance sector, we welcome the IAIS' proposal to complement its indicator-based approach with a business segmented assessment as we believe is intended by the IFS approach. From a conceptual perspective, this approach may have the potential to become a sensible analysis of the sources of systemic risk in insurance. However some important details of how the IFS approach would work in practice require further elaboration. An example in this case is the arbitrary segmentation of traditional, semi traditional and non-traditional which in our view remains questionable. By way of example, we oppose considering trade credit insurance as a semi traditional activity, given that it meets all the criteria described by the previous IAIS paper "Insurance and Financial stability". In addition other classifications included in the illustrative allocation according to table 1 need to be reconsidered. Despite this we would like to see the approach further developed and potentially given a more significant role in the assessment process.

7. Given that the intention of the IAIS methodology is to identify insurers whose distress or disorderly failure would cause significant disruption to the global financial system, we do not believe it is appropriate that the methodology involves making a comparison using only data reported by other insurers. In order to correctly evaluate the systemic risk resulting from an insurer's engagement in a certain activity we believe it is important that the extent of an insurer's involvement is compared with the wider financial markets and not just a select group of insurers.

8. INIA wishes to reiterate its doubts as to whether the proposed approach consisting in identifying insurers which have the potential to pose a systemic risk fits the specificities of the insurance industry, as described by the IAIS in the introductory part of its document

9. Having regard to the specific characteristics of the insurance sector, INIA is of the opinion that an alternative approach should be considered by the IAIS. Following an initial pre-screen based on publically available information and objective criteria, the focus should be exclusively on the non-traditional and/or non-insurance activities which have the potential to generate systemic risk. We believe that given that traditional insurance activities are recognised as not being a source of systemic risk insurers engaged exclusively in traditional activities should be excluded at an early stage of the identification process. Following this, we would suggest applying the following process for the identification and treatment of systemic risk concerns:

    a. Firstly, we propose a screening process aiming at identifying companies involved in non-traditional and/or non-insurance activities using information reported as part of an insurer's normal periodical supervisory reporting. This process would utilise available data from regulators and or financial reports, and apply relevant categories (such as size, interconnectedness, time or substitutability) and metrics exclusively to such activities to identify whether the conduct of the activities is potentially systemically risky.

    b. After the screening process, we propose to apply measures targeting the activities identified in stage 1 as having the potential to pose a systemic risk, taking account of mitigating factors and existing legislation.

10. INIA would like to emphasise the importance of ensuring that the implementation of the methodology is transparent to insurers. This objective cannot be achieved if insurers do not have a clear understanding of how a "G-SII" designation has been arrived at, and what actions could be taken to achieve a different outcome. The complexity of the current methodology with its multiple assessments, and the substantial contribution to the final 'indicator score' of factors that will be unknown (and unknowable) to individual insurers currently make such an understanding impossible.

11. We also note that although policy measures will only be applied from 2017, being designated as a "G-SII" has the potential to have a significant detrimental impact on the public and market perception of an insurer. Uncertainty over the potential policy measures that could be applied will only exacerbate this reaction. We regret that the original timetable for and co-

ordination of consultations on the methodology and measures has been disrupted. This has not only obstructed a thorough analysis of the methodology (which is inherently intertwined with the policy measures that will be applied as a result) – but led to a situation in which there will apparently be no opportunity to comment on, analyse or even react to the final methodology before it is simultaneously unveiled and applied to produce a first list of "G-SII"s. We therefore urge the IAIS to delay both the application of the methodology and the proposed publication of institutions determined as "G-SIIs" in order to provide the opportunity for comment on the final methodology and measures together and to anticipate their impact.

12. INIA would also welcome clarification of the process through which an insurer could be designated as a G-SII. We believe it is important that a right of response of the concerned insurer to designation as a G-SII should be established and included in the process.

13. Despite our preference for the alternative approach proposed in paragraph 9, the following sections contain a number of comments on the proposed methodology and envisaged measures.

II. Assessment methodology for systemic importance of G-SIIs

14. INIA's main concern on the proposed methodology is that it does not seem to be fully consistent with the IAIS' own assessment of the potential sources of systemic risk in insurance, as detailed in paragraphs 7-19 of the consultation document and in the paper "Insurance and financial stability" published in November 2011. Specifically, in our view the proposed methodology will result in capturing in a list of G-SIIs insurance companies involved in traditional activities, in spite of the recognition that such activities do generally not generate systemic risk. A number of amendments should be made to the proposed methodology in order to avoid such a situation.

    INIA believes that it is important for the IAIS to carefully consider the incentives and unintended consequences which may result from the selection of certain criteria. The inclusion of reinsurance as an indicator is a good example of this. Through including this criterion it encourages reinsurers to limit their sale of reinsurance and thus limit their risk diversification. This would clearly undermine the important financial stability role provided by reinsurance. Although it decreases their perceived "impact" of failure it comes at the cost of a higher probability of failure for the covered reinsurers. Another example is provided by the indicator 'intra-financial assets' and 'large exposures' (potentially including government issued bonds) as some companies could decide to take action by selling certain assets. Such an operation, if conducted on a massive scale by several companies at the same time, could have important destabilising effects in the markets

15. INIA considers in particular that the size factor is given excessive importance by the IAIS' proposed methodology, being used in three different instances: as an initial filter for the sample, directly as a specific category and indirectly, in other indicators from different categories. The focus on size will introduce a considerable bias to results of the identification process. In order to avoid a situation whereby the size of an insurer will ultimately determine its systemic relevance, we would suggest using it only in the initial filtering process. This would reconcile the need to establish a starting point for considering the relative systemic relevance of insurers with the consideration that size plays a positive role in the effective risk management of traditional insurance activities.

16. In addition to our concerns on size above, we would also disagree with the inclusion of the categories of "global activity" and "substitutability". With respect to size and global activity we believe they are representative of good risk diversification as the IAIS acknowledges (Par 8). With respect to substitutability we question this category as we are of the belief that failure of a specific sectoral insurer will not trigger a systemic event. In this regard, it is important that the difference between 'substitutability' and 'un-insurability' in the insurance sector is properly understood. The latter being the result of an appropriate economic assessment following a

change in market conditions. In defining substitutability the IAIS makes reference to provision of certain classes of traditional insurance (marine and aviation). It should justify the basis on which these activities have been picked out. The IAIS should also affirmatively state that there are classes of traditional insurance which are not subject to any substitutability risk, such as life insurance. INIA believes that a gap in coverage relating to such traditional insurance activities may, in exceptional circumstances, cause a temporary disruption in a particular economic sector however it is not a systemic event. This contrasts with the banking sector where a disruption in certain key infrastructure (e.g. payments system) would have an immediate systemic knock-on effect on the global financial system and economic activity.

17. With respect to specific indicators, we are in particular concerned about the inclusion of an indicator related to reinsurance. This appears to be at odds with the role of reinsurance as expressed in paragraph 16. The INIA comment on the non-systemic nature of reinsurance is further reinforced by the recent IAIS report on reinsurance and financial stability, which states *"traditional reinsurance and the bulk of alternative risk transfer mechanisms utilised by reinsurers are not, and do not have the potential to be, sources of systemic risk*[1]. Therefore we would strongly urge the IAIS to exclude reinsurance from the interconnectedness indicators.

18. The inclusion of indicators relating to investments such as intra financial assets and large exposures also raises questions, on top of the concerns relating to financial stability expressed in paragraph 15. Given the longer investment horizon of insurers, the possibility for "fire sales" of such assets is limited. Insurers as investors are far more likely to exercise a stabilising effect on markets.

19. We would also query the inclusion of an indicator related to variable annuities in the NTNIA section as we regard variable annuities as being a traditional activity and also not a source of systemic risk. Indeed the classification of variable annuities as an NTNIA is in contrast to their classification under the IFS methodology where they are included as a "semi-traditional" insurance activity. The financial crisis of 2008-09 provided a 'stress test' of the difficulties of providing guaranteed returns to policy holders in a situation of significant market stress. Insurers effectively managed their exposure to the product and there was no evidence of an 'acceleration of asset sales to pay guaranteed amounts' as suggested by the consultation. We would strongly urge the IAIS not to include a measure of variable annuities as an indicator.

20. With regards to suggestion of including further indicators as described in paragraph 34, we think that an indicator which accounts for the amount of derivatives trading without hedging purpose in economic terms could, if well-defined and if focused specifically on systemically risky NTNIA, have the potential to be appropriate for the final methodology. On the other hand, when considering the liquidity of insurance liabilities, we believe that disincentives such as tax benefits and inability of replacing contracts under the same conditions, should be taken into account, and therefore the extent of liquidity of insurance liabilities should not include traditional insurance activities.

21. INIA would welcome further details on how the IAIS proposes to reconcile the use of diverse accounting standards in the calculation of the proposed indicators. It is not clear in the document whether IAIS will take into account the effects from different accounting standards (SAP, US GAAP and IFRS) in order to ensure that the numbers provided by the different groups/entities are effectively comparable.

22. INIA understands that it is the IAIS' intention to use the assessment methodology to enable a comparison of an insurer's relative exposure to systemic risk. It is also stated in the section on

[1] We note that, while Table 1 lists alternative risk transfer (ART) mechanisms, including insurance linked securities, as "non-traditional", the IAIS' recent paper on "Reinsurance and Financial Stability" finds that traditional reinsurance "is unlikely to cause, or amplify, systemic risk . . . The findings also apply to the bulk of non-traditional (re)insurance and in particular to ART activities." (Reinsurance and Financial Stability, April 19, 2012, p. 5.) Therefore we urge that ART mechanisms continue to be excluded from the list of indicators under "interconnectedness".

the cut-off point (paragraph 44) that it intends to compare the list of systemically important insurers with a similar list of banks. In theory INIA welcomes a comparison between companies and sectors in terms of the systemic risks they pose; however, it is difficult to see in practice how the proposed methodology enables an effective comparison both between insurers and across different financial market sectors. In our view, comparisons based on indicators calculated on a gross basis will be limited to measuring the relative size of one institution to another and are not necessarily appropriate in assessing the systemic risks posed by a particular institution. As INIA has previously remarked on a number of occasions, size means very different things to insurers and banks.

23. INIA welcomes the existence of additional qualitative and quantitative assessments, including supervisory judgement (Par 23 page 11). In exercising this supervisory judgement we would like to urge the IAIS to clarify the role of the IFS assessment in this process and to take into account existing and future supervisory/regulatory frameworks as well as other mitigating factors (e.g. effective risk management, reinsurance, use of derivatives for hedging).

24. INIA welcomes the fact that the group supervisor can challenge the findings of the assessment methodology, as stated under paragraph 51. INIA believes that the group supervisor is best placed to consider the relative riskiness of an insurance entity and therefore believes that the role of the group supervisor in the assessment process should be further expanded to include decision making powers. In this regard, we consider that the group supervisor should be granted a veto role. It should be noted however, that some markets are still evolving their regulatory system to have a single group supervisor, and currently operate through a collective process of functional regulators for a given group. However the group supervisor would operate within their national statutory authority: nothing is intended here to extend statutory authority of a regulatory/supervisor over activity in another jurisdiction where they currently have none .These systems should be recognised and provided with the same authorities as a single supervisor consistent with national law.

25. INIA believes that it is important to establish a two-way dialogue between the IAIS, the group supervisor and any insurer under consideration of designation as a G-SII. This will provide the G-SII candidates with the opportunity to ensure that information is correctly and accurately collated/ interpreted and also enhance the transparency of the process to insurers involved. In addition, we believe that the process should allow for any institution classified as a G-SII to challenge a decision on its own initiative in a transparent legal appeal process.

26. INIA would also welcome clarification on which body will be responsible for the collection, use and storage of the data used to identify G-SIIs. The suggested indicators incorporate data which could be regarded as material non-public information. We would welcome further clarification from the IAIS on the steps which will be taken to guarantee the data remains confidential.

III. Policy measures for G-SIIs

27. INIA will wait for the final measures proposal before making more detailed comments. However, as a general comment we would like to express our concern that the envisaged measures seem designed to target individual institutions as opposed to specific risky activities. In our view, such an approach is unlikely to properly address the specific potential systemic risk related concerns identified.

28. We believe the process of identifying systemically risky insurers and the measures to be applied to those same entities cannot be considered as separate issues. It should follow that the process which establishes the cohort of systemically risky insurers should also be directly linked to the measures to be applied.

29. In addition, a set of measures targeted only at insurers designated as G-SIIs in a holistic manner risks creating an uneven level playing field between the identified G-SIIs and other insurers. The application of different rules to institutions that pose a systemic risk is based on the FSB rationale that the failure of certain financial institutions (specifically banks) generates significant externalities which can have a substantial impact on both economic and financial stability. As a result, the orderly resolution of failing institutions is imperative from an economic perspective. The differential treatment for these entities can be perceived as leading to a competitive advantage for them, which justifies specific measures such as a "capital surcharge". This is however a process that is particular to the banking sector. We do not believe that the same dynamic exists in insurance. If a particular activity which insurers are engaged in is judged to be risky, then the activity should be more appropriately regulated rather than applying measures to a cohort of larger institutions.

30. We do not regard the imposition of a Higher Loss Absorbency regime as being effective or practical for the insurance industry. As the IAIS acknowledges in paragraph 66 of the consultation, there is no global basis for adopting capital add-ons in insurance. INIA defends that a capital surcharge should only be envisaged for systemically risky non-insurance activities which have the potential to trigger a systemic reaction and where there are no equivalent tools or regulation available to the supervisor at national or regional level.

31. INIA is of the opinion that any measure should be applied taking into account the existing and proposed diversity of national/regional regulatory frameworks as well as other mitigating factors, such as the presence of contingency plans, orderly wind-up processes or enterprise risk management, among others. In our view, measures specific to G-SII's cannot be simply added to the existing layer of regulation or supervision.