GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

25 January 2016

Response to the IAIS consultation on the proposed updated assessment methodology for Global Systemically Important Insurers (G-SIIs)

Answers to consultation questions:

Question 1: *Is the use of absolute reference values appropriate for the indicators for reinsurance, financial guarantees, and derivatives trading (CDS sold)?*

The Global Federation of Insurance Associations (GFIA) welcomes the use of absolute reference values for certain indicators. Moving towards the use of truly absolute values, and away from the relative ranking system of the current G-SII assessment methodology would greatly improve the process in the future because it would more accurately reflect a company's potential exposure to or transmission of systemic risk to the financial system instead of a relative ranking of companies against each other. Absolute values would also further increase transparency and certainty.

GFIA would highlight that the use of absolute reference values needs to be combined with an absolute threshold for the level of activity that would lead a company to be considered systemic. Activity below this level should be excluded from the assessment score as it would not be a relevant contributor towards systemic risk. This absolute threshold should be set in the context of all participants in the financial system and should not be based on a relative ranking of insurers under the new method. Otherwise, the purpose of assessing the contribution of the insurance industry to global systemic risk would be defeated because only a measure of contribution relative to other insurers would be provided. In addition, more transparency regarding the threshold which divides the sample of insurers into candidates and non-candidates is needed.

The proposed methodology only uses absolute reference values for three indicators: derivatives trading (credit default swaps sold), financial guarantees and reinsurance. GFIA believes this is not sufficient and that absolute reference values should be applied to more indicators and particularly when insurers are one of the many participants in the financial system.

Finally, it would be helpful if the IAIS would include in the methodology a numerical example including a hypothetical insurance group that would show how the quantitative methodology, with absolute reference values for some indicators, would work. This would clarify the operation of the formula.

Question 2: *Should the IAIS consider measuring other indicators by absolute reference values? If yes, identify the indicator, explain the absolute reference value that can be used and explain why the use of the absolute reference value would improve the Proposed Methodology in the future.*

Use of absolute reference values is the more appropriate method to determine the contribution of insurers to the global financial system, especially where insurers are one of many participants (eg in the use of derivatives). GFIA believes it is not sufficient to use absolute reference values for three indicators only and would strongly suggest that these should be applied to more indicators. Relative measures are not suitable as they do not determine the potential risk to the global financial system. Applying absolute references to all suitable indicators will help the IAIS determine whether the insurance sector's specific activity is sufficiently significant to be considered an appropriate indicator of systemic risk. In particular, absolute reference values should be applied to several indicators related to size, interconnectedness and NTNI activities. As mentioned in the response to question 1, the use of absolute references needs to be combined with an absolute threshold for the level of activity that would lead a company to be considered systemic.

Question 5: *Are BIS statistics on the overall global CDS market an appropriate absolute reference value for the derivatives trading (CDS sold) indicator? If so, how should this absolute reference value be used by the IAIS? What other information or data could be used as an absolute reference value for the derivatives trading (CDS sold) indicator?*

It would make sense to build a ratio between the CDS sold by the sample insurer and the overall global CDS market. The Bank of International Settlements (BIS) statistics provide the only public and quantified data on traded derivatives. However, the BIS data should be tested against information submitted by the Global-Systemically Important Banks (G-SIBs) on CDS to ensure their reliability.

Question 6: *Are total global reinsurance premiums written an appropriate absolute reference value for the reinsurance indicator? If so, how should this absolute reference value be used by the IAIS? What other information or data could be used as an absolute reference value for the reinsurance indicator?*

GFIA would point out that no case has yet been made for considering reinsurance as giving rise to systemic risk. Therefore, reinsurance should not be included in the list of indicators. Instead, reinsurance should be incentivised as a stabilising factor to the financial system rather than penalised.

If the IAIS is determined to retain reinsurance in the list of indicators, it should consider carefully before switching to absolute reference values for reinsurance, as it is difficult to assess what difference this would make. Paragraph 22 suggests that alternative capital sources will constitute an increasing portion of the global reinsurance market; then this will reduce any extent to which reinsurers could possibly give rise to systemic risk and the methodology should take this into account. At the same time, in this scenario, the IAIS should be able to assess such alternative capital sources for systemic riskiness.

Global reinsurance premiums need to be placed in the context of all risk intermediation. That is, the indicator should be based on assumed reinsurance premiums as a share of the total primary insurance market. The choice of absolute value for the indicator should recognize that the current reinsurance market is not characterized by any individual reinsurer being a source of global systemic risk. Therefore, the absolute reference value should be set such that no individual reinsurer is designated primarily on account of its traditional reinsurance business.

In general, the systemic riskiness associated with reinsurance should not be overstated. On an absolute basis, it should only be possible for the very largest reinsurance premium incomes to give rise to systemic risk scores. The use of absolute reference values for reinsurance may therefore provide a better indication as to the level of use of reinsurance relative to the reinsurance market as a whole rather than a subset thereof. Nonetheless, the underlying assumptions that reinsurance contributes to systemic interconnectedness or that exposure measures can be used which do not take into account the risk mitigating benefits inherent in the use of reinsurance are not appropriate.

Question 7: *To what extent are large exposures an appropriate indicator of an insurer's interconnectedness with the financial system? What is the appropriate way to measure or understand the interconnections between an insurer's large exposures and the financial system?*

GFIA agrees with the removal of the large exposures indicator from the quantitative indicator-based component in Phase II; however, GFIA disagrees with considering it as an additional indicator during Phase III analysis. Investing large exposures and maintaining interconnections with the financial system comes naturally with insurers acting as institutional investors. GFIA believes that large exposures management is a micro prudential issue, as large exposures do not create linkages that result in the transmission of risk to the system. Consequently, the large exposures indicator cannot provide relevant information for the purpose of systemic risk assessment.

Question 9: *To what extent is the derivatives trading (excluding hedging and replication) in economic terms indicator an appropriate indicator of NTNI activities? What is the appropriate way to measure or understand the systemic importance of speculative derivatives trading?*

GFIA disagrees with the suggestion that insurers use derivatives for speculative purposes. In most jurisdictions, insurers are prohibited from speculative derivatives trading and these are instead used for hedging and risk management purposes. The focus should be only on derivatives that are uncollateralised. The analysis should also consider structures where the risk isn't materially offset (e.g. offsetting long and short positions within a fund).

Gross notional value of derivatives held is considered an indicator of interconnectedness. In GFIA's view, the IAIS should focus on the net fair value of the derivative activity it considers as NTNI and exclude derivatives used for what are deemed traditional purposes from the assessment methodology. When there are specific positions where the gross notional values materially misrepresents the risk, these should be netted down.

Question 10: *The weightings in Phase II of the Proposed Methodology emphasize the insurer's NTNI activities (45%) and its interconnectedness (40%). Are there any developments or trends in the global insurance market that warrant further refinements to the 2013 Methodology, potentially including changes to the category weightings? Please explain your answer.*

GFIA believes that interconnectedness indicators do not provide meaningful results in terms of systemic risk, whereas size and global activity actually improve the risk-absorbing capacities of insurers. GFIA understands that the concept of interconnectedness is linked to the Financial Stability Board's (FSB) definition of systemic risk. However, the proposed measurement of interconnectedness does not appropriately reflect the potential transmission of risk from the insurance industry to the system. While GFIA believes that there is a place for assessing an insurer's global footprint in the methodology, the criteria for global activity is too blunt an instrument because it applies the number of countries operated in without considering the materiality of an insurer's exposure in those countries. This criterion should be removed or refined to identify the materiality of systemic exposure a firm has in the country or countries it operates in.

Question 11: *Will the responsiveness of the derivatives indicator in the interconnectedness category be improved by using other data such as an appropriate net fair value figure (either positive or negative)? If so, what are more appropriate data and what is the appropriate way to use such data to measure or understand the interconnectedness caused by derivatives transactions? Should the IAIS measure interconnectedness with respect to derivatives transactions in the same manner as the BCBS? Please explain your answer.*

Irrespective of the technical implications of raising meaningful data on derivatives, the more important question is what economic purpose derivatives serve. GFIA understands that derivatives traded for profit (speculative) reasons are addressed in the NTNI category as far as CDS sold are concerned, whereas other profiles will be assessed in Phase III of the evaluation.

The derivatives addressed in the interconnectedness category are part of a hedging strategy determined to secure market positions or policyholder options. The use of derivatives for hedging purposes is part of the asset-liability management of insurers, intended to mitigate risks rather than amplifying them. Therefore, these transactions should not be considered systemically risky at all and the framework should consider how risk is managed through regulatory initiatives such as Dodd-Frank, the European Market Infrastructure Regulation (EMIR), and collateral mechanisms.

The derivatives indicator should be improved to focus on potentially systemic activity. A first step would be to distinguish between derivatives used for replicating, hedging and trading and pure speculations. Vanilla derivatives used to better match liabilities should be stripped out. Risk mitigation from collateralisation and clearing should also be fully acknowledged.

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Question 12: *How can the reliability and responsiveness of any indicator, including those mentioned above, be further improved, modified or revised for the Proposed Methodology?*

GFIA believes that some of the transactions listed as content for indicators that remain in the proposed methodology may not always provide relevant information for the purposes of assessing insurers' exposures to systemic risk. When the outcome is apparently irrelevant to the rationales for data collection, the IAIS should communicate with group-wide supervisors to determine exclusions of such indicators from data collection. In particular, GFIA would highlight that:

- The short-term funding indicator should be improved to focus on potentially systemic activity related to securities lending rather than measuring all securities lending (ie focus on securities lending used for maturity transformation and collateral hypothecation, and exclude "vanilla" securities lending which is not NTNI). For example, data should be collected for the short-term funding indicator only when collateral received is directly reinvested.
- Regarding liability liquidity, there needs to be a distinction between the theoretical possibility of surrender and actual expected behaviour as the policyholders will have other associated benefits which are valuable (eg insurance cover, guarantees).
- The level 3 asset indicator should be removed as it does not take into account the asset-liability management or insurers' long-term investment role. For example, level 3 assets may be backing non-liquid liabilities and therefore in such circumstances there can be no fire sale concerns. Therefore, if the indicator were to be retained, where level 3 assets are held to back non-liquid liabilities they should be excluded.
- Intra-financial assets expose insurers to systemic risk, but do not create systemic risk. The IAIS argument that there may be a fire sale of these assets seems exaggerated in the context of creating systemic risk.

Question 13: *What criteria, other than those listed above, should the IAIS consider when determining whether to include an insurer in the Phase I data collection?*

In general, GFIA is unconvinced that there is any link between many of the criteria specified and global systemic risk. To reiterate the IAIS's own views: *"there is little conceptual reason for life and non-life insurance activities to either trigger or amplify systemic risk."* The criteria seem to relate simply to amounts of assets and premiums, even though large-scale "traditional" insurance activities do not give rise to systemic risk. Large insurers with no or only limited exposure to systemically risky activities will therefore be investigated, whereas theoretically if a smaller insurer would engage in a large number of such activities, it would avoid scrutiny. More information about the process which has led to the selection of figures and ratios would be needed.

Question 14: *What are the strengths and weaknesses of consistency and relative annual stability as a guiding principle for establishing the quantitative threshold in Phase II? For purposes of establishing the quantitative threshold, what other principle(s), if any, should the IAIS consider?*

Given the large impact of the G-SII identification exercise on insurers' business strategies and capital policies, it is critical that insurers are able to determine the probability of their designation. GFIA supports the IAIS's proposal to consider the principle of consistency and relative stability in the quantitative threshold year-over-year, on the premise that the current methodology which only uses relative reference values will be modified to include absolute reference values for certain indicators. GFIA also suggests that the IAIS consider principles related to transparency and the use of absolute numbers, instead of a methodology that is reliant on relative values.

The threshold which will separate the sample into a group of candidates and a group not envisaged for G-SII designation is the most important junction of Phase II. GFIA strongly believes that this junction should be subject to a maximum degree of transparency. Undertakings need to know and understand why and based on which analysis the IAIS settled on the threshold. It is essential that this analysis is focused on systemic risk considerations instead of simply dividing the sample into groups in order to comply with the process. Consistency means that a threshold calibrated along these lines should not rule out the possibility that no individual insurer would eventually qualify for G-SII designation. Moreover, it is important that the process to establish the threshold remains flexible to be aligned to future developments, if necessary. Therefore, GFIA understands the principle of relative stability in a way that once the IAIS has agreed on a threshold, it will be applied for the assessment process of the corresponding year (ie there will not be retroactive changes).

Question 15: *For purposes of establishing the quantitative threshold in Phase II, what other approaches, if any, should the IAIS consider? What are the strengths and weaknesses of the alternative approaches, as listed above, to determining the quantitative threshold?*

To ensure fairness on a cross-sectoral basis, comparison to G-SIBs would seem the most appropriate basis for determining the quantitative threshold. Banking is inherently systemic, but the threshold for G-SIBs has been set so that only the most systemic banks are designated. Therefore, it would be appropriate for the threshold for insurers to be set at a comparable level to the G-SIB threshold.

Question 16: *While the majority of the Proposed Methodology will be based on quantitative outputs, what specific qualitative aspects of a potential G-SII should be considered in Phase III that are not captured in Phases I and II?*

A robust qualitative evaluation is necessary to ensure an accurate and comprehensive understanding of insurance firms. Specifically, the methodology should recognise and better incorporate product and risk management tools, both in Phase II and Phase III. For example, there are some risk management practices, such as liquidity management, collateralisation, and separate accounts that can limit the impact on other financial institutions if the insurer were to fail. Insurers should get full credit for that. In addition, recent regulatory changes mean that some of these practices, such as collateralisation, will be used even more by insurers.

GFIA recommends that the IAIS identify objective and quantitative references for risk management practices such as those mentioned above, and that it incorporate those references into the Phase II quantitative analysis. This would allow the IAIS to reward and encourage good risk management practices. Because Higher Loss Absorbency (HLA) "buckets" depend on the Phase II score, incorporating quantitative metrics for risk management in Phase II would also ensure that G-SIIs are placed in the appropriate HLA bucket.

GFIA welcomes the fact that the IAIS proposes to consider insurers' exposure to large counterparties only qualitatively, as this does not indicate the impact of the insurer's failure on the system. The same principle needs to be applied to other indicators and a distinction between insurers' exposure to systemic risk and the system's exposure to insurers needs to be made. Phase III should also include an assessment of the reliability of Phase II data and, in particular, its relevance to systemic risk.

The qualitative assessment should also take account of other potential mitigating factors such as the financial strength of the insurer and existing local/regional regulatory and resolution regimes and loss-absorbing capacities of insurance guarantee schemes, if those are available.

Finally, while GFIA supports the Phase III qualitative review concept, it should also include assessment of the qualitative data to ensure that it adequately reflects potential systemic risk if it is to be included within the prospective G-SII's score. It should also consider ancillary factors and risk management in determining the degree of any residual potential residual risk that cannot be contained within the insurer. It is important that there is consistency in the application of the qualitative assessment, and therefore the IAIS should produce supervisory guidelines and subject this to peer review.

Question 17: *What constraints should be imposed on the use of non-quantitative analysis of the potential systemic importance of insurers in the Proposed Methodology? To what extent, if at all, can qualitative analysis enhance the IAIS's understanding of the systemic importance of a potential G-SII?*

The qualitative analysis (Phase III) allows the IAIS to comprehensively evaluate a firm in ways that the quantitative analysis does not allow. This is especially important given the great heterogeneity within the insurance industry. A G-SII methodology that is purely quantitative or too heavily weighted in favour of quantitative metrics to the exclusion of qualitative analysis will not properly capture the heterogeneity of an industry that features different business structures, different business models, different lines of business, different geographical exposures, different products in emerging and developing markets. A qualitative analysis (Phase III) allows the IAIS to account for these differences in a way that a quantitative analysis is unable to capture.

GFIA recommends that the IAIS consider what role the qualitative analysis should play in determining a firm's Phase II score, which determines a G-SII's HLA "bucket" assignment. Currently, the outcome of Phase III does not impact a G-SII's Phase II score "unless the Phase III analysis reveals there are substantive errors in the data submitted by insurers". GFIA believes that the findings from Phase III, particularly those involving risk management tools, should influence the Phase II score. In GFIA's view, it is possible to develop objective references to measure a number of risk management tools and to incorporate those references into the Phase II quantitative analysis. This would allow the IAIS to reward and encourage good risk management practices.

Finally, while GFIA supports the Phase III qualitative review concept, it should not be used to allow an insurer that is under the quantitative threshold to be considered for G-SII designation.

Question 18: *What other indicators, if any, could be considered by the IAIS to inform the supervisory judgment aspects of the Proposed Methodology?*

Whether the group falls within the definition of a financial conglomerate could be an appropriate indicator to include within the interconnectedness category to provide a focus on any potential complexity and interconnectedness that may be present where a group has material business in other sectors, such as banking.

Question 19: *How can the additional information collected in the supplementary reinsurance-specific questions as part of the data collection be relevant to better assess the potential effects of a reinsurer's failure on other reinsurers or primary insurers? Should the IAIS set a threshold amount of third-party* *reinsurance activities that must be exceeded by an insurer in order to be required to complete the supplementary reinsurance-specific questions in Phase 1? If so, what should be the level of the threshold?*

GFIA does not understand the purpose of the Reinsurance Supplemental Assessment. The IAIS has looked at reinsurance in detail and has concluded that *"traditional reinsurance is unlikely to cause, or amplify, systemic risk."* It is then unclear why there should be a need for additional analysis of an undertaking's reinsurance activities in Phase III, particularly since there is already a reinsurance indicator in Phase II. If such an assessment is to be carried out, it only makes sense instead of rather than in addition to the Phase II reinsurance assessment.

The assessment of the potential effects of a reinsurer's failure on other reinsurers or primary insurers should take full account of the IAIS's own work on extreme stress scenarios, the conclusion of which was: "The results are similar for both primary insurers and reinsurers. The impact on equity capital (which in this context serves as a proxy for solvency) of severe financial market crises far outweighs the adverse effect of large catastrophic loss events. Adding the default of one large reinsurer would make a comparatively small contribution to the total losses absorbed by primary insurers."

In addition, the IAIS report "Reinsurance and Financial Stability" dated 19 July 2012 concluded that "*as far as traditional reinsurance activities are concerned, the potential for adverse and potentially systemic intra-industry impacts is small and will likely be contained within the insurance sector*".

The Reinsurance Supplemental Assessment is unlikely to provide any new insights. Furthermore, any assessment methodology should be open and transparent and applied consistently by supervisors across jurisdictions. Clarity is needed on how this will be applied in general in respect of Phase III assessments and particularly in the case of the Reinsurance Supplemental Assessment, where it is a component of Phase III.

In GFIA's view, the right way to determine whether there is any systemic impact from the reinsurance activities of a failed reinsurer is to investigate the exposure the primary insurers have in terms of reinsurance liabilities to the failed reinsurer and determine whether there would be a critical impact on the primary insurer if those liabilities would not (or not entirely) be fulfilled.

However, GFIA suggests that the IAIS should set an absolute threshold for the determination of whether a (re)insurer will be subject to completing the supplementary reinsurance-specific questions (eg more than 5-10% of its total insurance activities attributable to third-party reinsurance).

Question 20: *Are gross written premiums, technical provisions or exposures an appropriate way to measure and/or understand the interconnections between an insurer's third-party reinsurance activities and other primary insurers and reinsurers?*

GFIA believes that gross written premiums are an appropriate way to measure the interconnections between an insurer's third-party reinsurance activities and other primary insurers and reinsurers. However, the level of interconnections has limited value in terms of systemic risk. Measured by absolute reference values, only around 5% of global written insurance premiums are ceded to reinsurers.

Question 21: *How could the information collected be used to evaluate the extent to which an insurer's third-party reinsurance activities disperse or concentrate risk in the global insurance market?*

It is known that the reinsurance market is more concentrated that the primary insurance market. The increased concentration may go along with a marginally higher counterparty default risk for primary insurers, however, not to such an extent as to make this risk systemically relevant.

Question 24: *What types and forms of information exchange with prospective GSIIs should the IAIS consider?*

There should be a frank and in-depth conversation between the IAIS, the relevant authority and a prospective G-SII. The IAIS should explain exactly how the assessment has been carried out and why the insurer has been designated as a prospective G-SII, so that the insurer has all the relevant information in order to be able to provide the IAIS with any additional information or arguments. During this dialogue, the prospective G-SII should have a chance to allay the IAIS' concerns, and this should then be considered in the designation process.

Question 25: *Is it reasonable for Phase 2 of the Methodology to be the basis for applying HLA to G-SIIs? Please indicate any alternative methods that the IAIS should consider for this allocation process. What constraints, if any, should be applied to Phase III's effect on the allocation of HLA?*

It is important that the HLA is based on appropriate data. Where Phase III assessment considers that the data is not indicative of potential risk (for example after considering the ancillary factors) then the data should be disregarded from the assessment and should not contribute to the G-SIIs overall score, as this could otherwise influence the bucket that the insurer is allocated to for the purposes of the HLA.

The allocation for HLA purposes should be communicated to the potential G-SIIs as soon as possible. Any fundamental changes of assessment due to discoveries in Phase III or even Phase IV must be considered in the HLA bucket allocation. The IAIS clearly states that the assessment process is not final before Phase V and the HLA allocation cannot be based on a preliminary result.

Question 26: *What factors, such as stability in the G-SII list, should the IAIS consider when determining the appropriate presumption period for G-SII status?*

In GFIA's view, a relevant factor would be whether a change in an insurer's overall score in the designation process was due to temporary factors, or whether it is indicative of a more permanent view. Where it is a temporary factor, this should not necessarily lead to an insurer entering or exiting the list, but where the change is indicative of a more permanent view, there should be no reason to delay the insurer's entry or exit from the list of G-SIIs. This should be discussed with the insurer as part of the information exchange.

GFIA does not agree with the two-year minimum presumption of G-SII status. It is not reasonable and proportionate for an insurer to remain on the G-SII list and subject to policy measures if it has taken satisfactory steps to reduce its systemic relevance. The stability of the G-SII list is not a value in itself that needs to be protected. The G-SII designation should be instantly effective without granting transitional periods.

In the situation where an insurer not previously identified as a G-SII will be recommended for identification, the IAIS should award the insurer some degree of flexibility. Namely, with regard to the requirements G-SIIs need to satisfy, such as additional funding, the IAIS could consider allowing a certain grace period that provides more time for the insurer to satisfy the requirements. This would be done based on close communication with the group-wide supervisor.

Question 28: *How and, if so, to what extent should the resulting score be communicated to the prospective G-SII?*

Every firm evaluated by the IAIS for prospective G-SII status should receive its score promptly after the conclusion of each phase of the methodology. Feedback is particularly important after Phase II, considering that the firms whose score is under the threshold lack information about the score. The resulting score should be communicated to the prospective G-SII within Phase IV of the methodology, where the IAIS, the relevant authority and the prospective G-SII will have an in-depth conversation about the assessment and resulting score, allowing the prospective G-SII to provide additional information and arguments to inform the G-SII designation.

It will be essential that the resulting score and the breakdown of how it has been calculated between the differing factors is clearly communicated to prospective G-SIIs to enable them to understand the nature of their designation and the actions they may need to take to address perceived systemic activity if they want to exit the list of G-SIIs.

Question 29: *How and, if so, to what extent should the data used for the calculation of the scores and the resulting scores be made transparent to the public? If made publicly available, who should disseminate this information? What factors should the IAIS consider in this respect?*

The data used for the calculation of the scores and the resulting scores should not be made publicly available, given that the assessment methodology has not been sufficiently established and contains some indicators that may not necessarily be relevant to systemic risk. Such data might mislead the public if published at this stage.

GFIA contact

Nicolas Jeanmart, chair of the GFIA systemic risk working group; jeanmart@insuranceeurope.eu;

About GFIA

Through its 40 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 60 countries. These companies account for around 87% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.