GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

25 January 2016

Response to the IAIS consultation on Non-traditional Non-insurance Activities and Products

Summary

The Non-traditional Non-insurance Activities and Products (NTNI) principles set out in the GSII Policy Measures document have given rise to a wide range of interpretations, and the IAIS was right to attempt to clarify the NTNI concept. However, the process proposed by the IAIS in this consultation for assessing NTNI status manages to be at the same time complex and arbitrary. The reason for this is that, on closer examination, the factors that lead to NTNI status are difficult to assess simply. This raises questions about the validity of the NTNI concept, and GFIA suggests that the IAIS should reflect further on this before pursuing further the process set out in the consultation document.

GFIA is also concerned that, once the NTNI category is affirmed, regulators across the globe might misunderstand the concept and develop restrictive rules for NTNI products (eg ring-fencing), leading to the penalisation of these products. If this happens, then the crude classification process described in Section 3.17 will not be adequate.

In addition, uncertainty about the scope of NTNI makes the consequences for policyholders and savings levels difficult to determine. The IAIS has so far analysed the issues entirely from the standpoint of financial stability. GFIA believes that a balance needs to be struck with consumer protection and the social impact on savings levels. The NTNI concept should not end up discouraging insurers from offering appropriate protection and savings products.

GFIA notes that the IAIS describes this consultation as the "first step" in a three step process to clarify the NTNI concept and as such much work will be needed to reach any conclusions on the determinant nature of what constitutes a NTNI. The NTNI principles included in Annex 2 will require testing and GFIA supports the IAIS' commitment to do so with input from stakeholders as appropriate. GFIA would like to underscore that it is paramount that the relevant stakeholders be part of this process in order to achieve the best possible outcomes in this regard.

The document is silent on the question of the authority responsible for making the assessment, and this needs to be clarified. The expertise of local regulators is essential, as they understand the products and their historic performance. Given the wide variety of products/business practices globally, the NTNI document and methodology might, in practice serve as an initial screen, with local regulators applying supervisory judgment and further robust analysis in phases 3 and 4 of the G-SII Designation methodology. On the other hand, GFIA expects regulators to work together to ensure a consistent approach to the assessment, and to ensure that the scope of NTNI does not inevitably expand, leaving insurers and their policyholders open to regulatory uncertainty about the status of new, emerging or changed products.

The document overstates, and in some instances improperly concludes, systemic risk associated with designated products, possibly as a consequence of the IAIS' focus on the contractual elements of NTNI. It is right to draw a distinction between vulnerabilities and transmission channels, but the logic of this distinction need to be followed through. Vulnerabilities only lead to systemic risk if they are transmitted

to the financial system and the wider economy. The transmission channels themselves can be blocked or slowed down by supervisory or management action, and this needs to be taken into account. We also note that exposure to economic downturns (a microprudential issue) should not be confounded with causes of systemic risk.

Specifically, the IAIS has taken an over-doctrinaire approach to the use of derivatives. Like any financial market, the derivatives market has frailties. Many of these have been addressed by the waves of regulation since the financial crisis. However, the IAIS insistence on ruling out any contribution that derivatives make to delivering the benefits of the policy effectively eliminates from the assessment the support of other participants in the market for those guaranteed benefits. It cannot be the case that policyholders are in exactly the same position as they would be if relying on the insurer's balance sheet alone.

Finally, GFIA notes that the paper is vague on how property and casualty insurance is to be treated by the NTNI framework. Annex 1 lists “certain types of property and casualty/liability insurance” as a product category for potential review – this is rather broad. Moreover, broad references to property and casualty insurance for review does not make sense in light of the IAIS’s prior statements. In its November 2011 "Insurance and Financial Stability" (IFS) paper, the IAIS stated that, “based on information analysed to date, for most lines of business there is little evidence of traditional insurance either generating or amplifying systemic risk within the financial system or in the real economy. Of course, empirical assessments about the systemic importance of insurers and insurance groups may change over time.” GFIA has no reason to believe that the IAIS has subsequently changed the classification of property and casualty insurance generally from “traditional.”

GFIA answers to the IAIS questions

Question 1

The NTNI label is misleading and could be prone to misinterpretation. Many insurance products that may be labelled as “NTNI” under the proposed framework are long-standing, prudentially regulated insurance products that are recognised globally. An alternative naming convention should be considered.

Question 2

It would be helpful if the IAIS could start by confirming that most insurance products do not contribute to systemic risk, citing their conclusion in the IFS and RFS papers.

GFIA members are agreed that the IAIS has not taken into consideration all the benefits and liquidity features needed for a full assessment of NTNI. However, the missing benefits and liquidity features differ depending on the jurisdiction and the nature of the products popular in that jurisdiction. So the responses of individual trade associations and companies will give a fuller response on this issue. However, for example, the benefits should include guarantees, and the liquidity features should include the economic costs of surrender.

Question 3

The analysis needs to draw a clearer distinction between vulnerabilities and transmission channels, in order to focus the analysis on fundamental, destabilising, cross-sector consequences that are necessary to identify a product as systemically risky. The vulnerabilities do not themselves lead to systemic risk. The vulnerabilities represent potential sources of risk to the insurer - but that is the concern of microprudential regulation. It is only when the vulnerabilities are transmitted to the financial system or to the wider economy that there is the potential for systemic risk.

In addition, existing supervisory frameworks and management actions reduce the chance of rapid and immediate transmission, both through the exposure channel and through the asset liquidation channel.

It is also a relevant consideration at the vulnerability stage of the analysis. As a consequence, the IAIS analysis greatly exaggerates the likelihood of systemic risk.

Question 4
The two step approach to identification of substantial market risk is helpful. Following this approach helps to make clear that some traditional insurance products, for example those which offer fixed guarantees, are not sources of systemic risk, and can be offered to policyholders free from the suspicion that the NTNI label would bring.

The assessment of market risk should take a more holistic approach and therefore take into account other risk mitigating measures, including the use of derivatives that help to reduce risk (eg for hedging).

Question 5
The list of benefit features is too narrow, and different jurisdictions will have benefits that the IAIS should take into account.

Question 6
The IAIS document has insufficient quantitative analysis to provide a robust justification for the risk classification attached to the time periods given. Further analysis is required. The period of time required will depend heavily on each insurer's ability to manage liquidity risk, and any general conclusions should be treated with caution.

In addition, the IAIS focus on contractual requirements does not take into account the possibility of regulatory measures. Mass surrenders of the kind feared by IAIS have been extremely rare events . In these unusual circumstances, it may be helpful for regulators to have the power to impose a temporary stay on surrenders. The advantage of this approach is that it does not place unnecessary burdens on policyholders who may wish to surrender their policies in normal economic conditions for reasons based in their own economic circumstances.

Question 7
The IAIS has focused on exit penalties as a disincentive to surrender. However, there is a very wide range of factors that act as brakes on policyholders considering the surrender of their policies. The document mentions tax considerations, but underestimates their impact. Other factors that should weigh in the mind of the policyholder are the loss of guarantees, loss of principal for savings products (i.e. where the surrender value is lower than the total or premiums paid), possible difficulty in finding a product with similar features, and the costs of switching products.

Question 8
The IAIS document has insufficient quantitative analysis to support the level of risk attached to the economic penalties identified, and further analysis is required. The right level would depend on the nature of the product in question, the insurer's risk management systems, the tax regime and so on. In general, the nature of insurance products is different from banking and investment products, and the risks of mass withdrawal much smaller. Alongside exit fees, there are a number of other disincentives to surrender that should be taken into account, including the loss of valuable benefits/guarantees, additional costs in securing alternative provision and tax implications.

This measure also requires a careful balance to be struck with consumer protection. Exit penalties are not popular with consumers, and this measure is liable to incentivise insurers to raise exit penalties to this level.

Question 9
The IAIS should clarify whether this assessment of liquidity risk applies to the impact on the insurer, or to the impact on the asset markets in question, as different considerations apply. The question itself implies that the IAIS is here concerned with assessing the impact on the insurer. However, most of the

material in Section 3 is focused on the exposure channel. This raises the question how the IAIS intend to assess the asset liquidation channel defined by the FSB.

Any assessment of the impact on the asset markets of transmission through the asset liquidation channel will vary depending on the markets, and the nature of the stress that gives rise to a mass surrender event. The proceeds of surrenders are not lost to the financial system, and will appear somewhere.

In any case, the assessment would benefit from a wider set of factors, and all the ancillary factors identified are relevant. The IAIS proposals for a methodology to identify and weight economic penalty and delay in access are already crude, and there is no reason why these ancillary factors cannot be weighted with equivalent accuracy, if that is desired.

Question 10
Further factors to be taken into account depend on the products in each jurisdiction, but will include management and supervisory action, and the cost of switching.

Question 11
Disentangling the savings and protection elements of products which contains both elements will depend on the nature of each product. The IAIS should take care to ensure that the long term nature of these products is taken into account. Protection features may not rank high in a policyholder's mind for long period of the product's duration, but may rank very highly in time of stress.

Question 12
The liquidity risk of the savings and protection elements will need to be considered separately. Any assessment will be heavily dependent on the nature of the product.

Question 13
The IAIS has identified a full set of factors which might potentially lead to systemic risk. However, as stated earlier the role of mitigating actions and factors in the transmission channels is systematically understated, with the consequence that the chances of systemic risk arising are exaggerated.

Question 14
GFIA has struggled to grasp the implications of a factor being relevant to systemic risk but non-determinative in the classification of a product as NTNI. Is it the case that these ancillary factors are non-determinative because the IAIS has focused on the contract features of the products undergoing assessment for NTNI status? Many of the factors that mitigate systemic risk, in particular insurers' risk management systems and the existing supervisory framework, will be left out of the assessment, leading to a distorted outcome.

GFIA therefore believes that whether these ancillary factors should be considered as determinative should be assessed based on further analysis of each factor's appropriateness. GFIA has some reservations about the factor labelled “lack of suitable assets for fixed benefit policies, which requires further elaboration. Much will depend on the interpretation of the word “suitable,” which is open to subjective reading. The inclusion of these ancillary factors in no way diminishes the need for supervisors to co-operate to ensure consistent application of the definition of NTNI.

Question 15
The list in Annex 1 is too vague to comment on meaningfully. What does "certain types of Property and Casualty/Liability insurance" mean? GFIA suggests that the IAIS should focus its resources on products more likely to fall within the definition of NTNI, rather than pledging to review lines that the IAIS itself has categorised as “traditional” and not likely to generate systemic risk.

Question 16
On the basis of this consultation document, it is premature to suggest revision of the NTNI principles. However, further consideration of the principles has demonstrated that NTNI is an elusive concept, difficult to determine with any certainty. GFIA suggests that the IAIS re-consider the validity attached to this concept before pursuing further the process set out in the consultation process.

GFIA contact
Hugh Savill, chair of the GFIA capital working group; Hugh.Savill@abi.org.uk;

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.