

IAIS Consultations

Print view of your comments on "Activities-based approach to Systemic Risk Consultation" -
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Jurisdiction	International
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Treat my comments as confidential	No

Question	
Answer	<p>Q1 Do you agree with the IAIS definition of an activities-based approach? If not, please provide an alternative definition and explain how it improves on the IAIS' one.</p> <p>The IAA supports the development by the IAIS of a pragmatic key indicator approach to identifying the key sources of systemic risk arising from insurance activity. The ABA approach shows promise in its attempt to identify sources of systemic risk and potentially policy measures to mitigate those risks.</p> <p>The definition provided (“an approach to mitigate systemic risk through broadly applicable policy measures addressing potentially systemic activities”) suggests that the IAIS will focus on the sources of systemic risk arising from “systemic activities”. The IAA notes that the proposed definition may leave readers with the impression that the IAIS is focusing on just a subset (i.e., systemic activities) of all the sources of systemic risk arising from insurance activity, whether from single entities or collectively from the insurance industry. Some sources of systemic risk become apparent only upon review of an entire jurisdiction or region. The IAA suggests that the ABA approach should be inclusive of all sources of systemic risk. The current draft does not make this clear. Further the ABA approach itself is not clear on its connection to current ICP 24.</p> <p>The IAA believes that insurance activity is much less of a source of systemic risk, especially global systemic risk, than is posed by banking activity. Nevertheless, insurance activity has resulted in (and may do so in the future) sources of idiosyncratic systemic risk which require monitoring, identification, policy measures etc. These examples of idiosyncratic systemic risk can pose material risk to a jurisdiction or a local region. Some specific examples could include the impact of the failure of HIH on the ability of firms to get replacement cover; the potential cascading impact of a DSII failure on the ability of the jurisdiction to cover the accumulated losses and/or provide continuity of claims payment, at least in the short term;; the impact of regulatory reporting and capital standards on insurer asset management due to capital volatility and procyclicality; cross-sectoral spillovers; the implications of group/conglomerate interconnectedness to a jurisdiction or region; emergence of “shadow insurance” activities which are un-regulated etc.</p> <p>The IAA suggests the IAIS has a responsibility to inform its members of their wider duty to assess systemic risks in their jurisdiction/region to help enable firms to manage/mitigate those risks better, and this should be made clear in the ABA approach.</p>
	<p>Q2 Does the proposed definition allow the assessment of the most significant potential sources of systemic risk?</p>

Answer As noted in the IAA response to Q1, the IAA believes that there are various potential ways in which systemic risk arising from insurance activity could emerge. The IAA views these exposures as being idiosyncratic (for the most part) rather than being global (exposure to low interest rates is certainly a global phenomenon at present). Hence the IAA believes that the ABA should seek to address all the material sources of systemic risk. Examples of sources of risk which would seem to easily fit into the ABA approach include:

- Insurers with large, poorly managed (and perhaps complex or misunderstood) risk exposures. Historically, life insurers have presented more examples of this than non-life (casualty) insurers due to risks arising from the asset (ALM) management by life insurers of their long-term policyholder obligations.
- Exposures of insurers, insurance groups or the industry to investments in non-insurance activities with potential systemic risk (e.g. AIG financial products division in the UK).
- Exposure of the insurance industry to macro-economic shocks or long-term trends such as forms of inflation, real estate returns, equity returns, interest rates etc. – again these are typically life or possibly health insurer issues. We understand that the intention is to consider insurers’ net exposure to these risks after risk mitigation efforts. We believe it is important that the reliability of such risk mitigation will need to be considered as these may vary between techniques such as ALM which are more in the control of the insurer to the rollover of derivative or reinsurance transactions which may be more challenging in stressed conditions when they are most needed. We have commented further on counterparty risk below.

It is unclear if other sources of systemic risk arising from insurance activity are included in the ABA definition. The following examples elaborate on some of the sources of systemic risk identified by the IAA in response to Q1:

- The impact of the form of regulatory reporting/requirements on the collective insurance industry product design and asset management behavior, by creating industry-wide “group-think”. For example, it has been suggested that a result of a move to a MAV and RBC framework is that insurers become sensitive to earnings and capital volatility. As a result, they may invest more heavily in certain types of assets while avoiding others. This behavior shift has implications for the financial markets, as well as life insurer exposure to credit, interest rate and ALM risks. These shifts could also impact policyholders due to product re-design, de-risking etc.
- The current focus of the IAIS on capital standards for IAIG’s neglects the possible systemic risk presented by non-IAIG insurers who are not subject to comparable (and in some jurisdictions “any”) RBC requirements. Most developed jurisdictions have in place well developed supervisory frameworks which include regulatory reporting and RBC requirements for all insurers. However, some regions/jurisdictions do not yet have RBC requirements in place for insurers. The potential spillover effects of financial distress in these regions/jurisdictions (both across the financial sectors within the region and beyond the borders of the region) should be considered by the IAIS as a possible source of systemic risk.
- The impact of cross-sectoral connectivity and consequent spillover of risk to/from insurers. Examples may include close ties (e.g. ownership, debt, investments etc.) with other parts of the financial sector; securitization activities; mortgage lending; use of derivatives etc.). However, ABA should be designed so as not to double count risks by including the systemic risk fully in both sides of a transaction, for example when considering the insurer as the customer for a bank in a derivative transaction.

Q3 What are your views on the comparison between ABA and EBA?

Answer It appears that the IAIS is promoting the ABA as an improved method of identifying systemic risk and that the EBA approach would no longer be pursued. If this is the case, the IAA believes that it should be made clear that the sources of systemic risk targeted by the EBA will now be captured by the ABA.

Q4 Do you agree with the IAIS’ conceptual approach? Please explain any suggested changes.

Answer The IAA is supportive of the four-step process described on the assumption that our concerns regarding the duty of IAIS members to monitor all sources of systemic risk arising from insurance activity (see IAA responses Q 1-3) are addressed.

Q5 Do you agree with defining the activities broadly in terms of risk exposures (e.g. liquidity risk) rather than more narrowly in terms of their legal form (e.g. securities lending)? If not, what changes should the IAIS make and why?

Answer	The IAA agrees with a focus on the substance of risk exposures not their legal form.
	Q6 Do you agree with the two main risk exposures identified for the purposes of an ABA? If not, how could this be improved?
Answer	As noted in the response to Q1-3, the IAA believes that systemic risk can arise from many sources, liquidity and macroeconomic risk exposures are two of them. In addition, the IAA notes that often the liquidity risk in insurers is driven by macroeconomic factors and care will need to be taken to look at the aggregate risk holistically.
	Q7 How should counterparty risk be treated under the ABA?
Answer	<p>The IAA agrees that assessing counterparty risk exposure is very important in entity and group level supervision. Counterparty risk arises from failure of the counterparty to honor its obligations in full or in part in a timely manner, thereby creating some combination of credit, liquidity and/or operational risk. The IAA agrees that counterparty risk need not be directly assessed by the ABA approach as long as that approach captures the credit, liquidity, operational risk etc., exposures inherent in dealing with counterparties.</p> <p>One of the defining qualities of groups, whether insurance groups or financial conglomerates, is the nature of the many linkages (not just ownership) which bind them together (see IAA Risk Book chapter 8, "Addressing the Consequences of Insurance Groups"). The nature of these linkages is frequently very important to the functioning of other members of the group.</p> <p>The IAA believes that study of these linkages is not only important to entity and group supervision but, in some instances, they may even be a source of systemic risk (i.e. large, cross-sectoral groups, significant to a jurisdiction/region). In some jurisdictions, bank ownership of insurers is significant and spillover counterparty exposure can be quite relevant. Other important sources of counterparty risk exposure may be reinsurance and derivatives. It is possible that study of aggregate counterparty risk exposures for their systemic risk implications is more meaningfully conducted at the jurisdiction or regional level (ie not globally). The IAA recommends that counterparty exposures be considered by ABA.</p>
	Q8 How should substitutability be treated under the ABA?
Answer	The IAA supports the IAIS view that substitutability is not a major source of systemic risk for the global insurance industry (although some DSII's may pose some substitutability risk in their jurisdictions).
	Q9 Should any other activity or risk exposure be considered potentially systemically risky under this framework?
Answer	Among the several potential sources of systemic risk which the IAA listed in its response to Q1, the IAA suggests the IAIS should also study the impact of regulatory reporting and capital standards on insurer behavior (e.g., asset choices, procyclicality etc.) as a contributor to systemic risk (e.g. see results of 2016 EIOPA stress test).
	Q10 Do you agree with the assessment of liquidity risk in the context of an ABA? If not, please explain why and how this could be improved.
Answer	The IAA understands the liquidity risk examples provided in the IAIS paper and affirms the need for ABA assessment. Liquidity risk tends to be experienced more by life than general insurers. However, the ABA should consider the potential impact of a large counterparty failure, such as that of a key reinsurer, on a general insurer, particularly at the jurisdiction level.
	Q11 Do you agree with the transmission channel, i.e. the reasons and conditions for this risk to be potentially systemic and how it is described in this section?

Answer	
	Q12 Are there additional examples of significant exposure to liquidity risk that should be considered?
Answer	
	Q13 Do you agree with the IAIS' assessment of macroeconomic risk in the context of an ABA? If not, please explain why and what changes you think should be made.
Answer	See previous comments to Q 2.
	Q14 Do you agree with the transmission channel, i.e. the reasons and conditions for this risk to be potentially systemic and how it is described in this section?
Answer	
	Q15 What are your views on the inclusion of the negative impact of reduced funding of other financial sectors?
Answer	The IAA concurs that changed (not just reduced) funding to-from other financial sectors, when observed in aggregate for a jurisdiction or region can be an indicator of changing systemic risk to the insurance sector. In addition, supervisors should be watchful for the development of shadow insurance activities in their jurisdiction.
	Q16 Are there additional examples for significant macroeconomic exposure that should be considered?
Answer	See previous comments to Q 2.
	Q17 What are your views on the IAIS' consideration of operational risk in the development of ABA policy measures?
Answer	
	Q18 What are your views on the IAIS' consideration of other common or procyclical behaviours that do not directly stem from either liquidity risk or macroeconomic exposure?
Answer	The IAA agrees that in today's environment, many insurers do "search for yield" where possible and allow for any attendant risks as well as aim to minimize earnings and capital volatility. The IAA suggests that a significant influencing factor in the latter is the emerging regulatory and capital requirements in certain jurisdictions which use market consistent valuation reporting along with capital requirements based on market based shocks. This procyclical environment enhances an insurer's earnings and capital volatility and drives their behavior to attempt to reduce this volatility. The IAA believes that this perspective (as previously mentioned in our comments to Q 2) should be addressed in the ABA approach.
	Q19 Do you agree with the description of how the existing policy measures could mitigate systemic risk?
Answer	<p>Paragraphs 62-69 are a useful reminder of current IAIS policy measures with the potential to address aspects of systemic risk. The diagram of the IAIS architecture of supervisory requirements and the listing of systemic risk related policy measures in Table 3 are helpful.</p> <p>However, the remaining paragraphs in this section (ending in para 89) provide no indication as to the placement of ABA within the current suite of IAIS standards. Is it the IAIS's view that ICP 24 continues to provide the overall principle and standards for addressing systemic risk by supervisors (supported by other policy measures in Table 3) and that ABA is a pragmatic tool for gathering systemic risk exposures?</p>

Q20 Are there other mitigating policy measures in the wider IAIS policy framework that should be taken into account? If so, what are these and how do they mitigate the risk?

Answer

Q21 Do you agree with the IAIS' description of the gap analysis? If not, please explain how it could be improved.

Answer

The IAA suggests that the value of the gap analysis can be enhanced through the widest possible inclusion of viewpoints on the sources of systemic risk. For example, insurers, industry, actuaries and the IMF/WB all have valuable perspectives. Specifically, the IAA advocates for the value from industry wide (within and/or across jurisdictions) stress testing as well as from ORSA's to help identify sources of systemic risk. Additionally, as stated in ICP 24, insurance supervisors will need to coordinate with other national authorities to conduct cross-sectoral spillover analyses.

Q22 Do you have any suggestion on how to measure (residual) liquidity risk in a proportionate manner?

Answer

Q23 How can the (residual) macroeconomic risk be appropriately measured, taking into account the extent that this risk is managed through ALM?

Answer

ALM is more fundamentally important to life insurers than to general insurers due to the nature of the products sold and their (typical) long-term nature. ALM is a complex matter for life insurers and their investment professionals and actuaries (see IAA Risk Book chapter 13, "Asset Liability Management") as the underlying insurance products may contain some combination of guarantees, adjustable features and embedded options. To better understand the possible impact of various macroeconomic exposures on insurers (individually and collectively) the IAA recommends the use of both ORSA results and industry wide stress testing as these techniques make use of insurers' expertise and specific knowledge of their ALM practices in developing the stress test results.

Q24 Are there any other important considerations that are not included?

Answer

Q25 Do you have any comments on the potential policy measures considered?

Answer

Q26 How should the IAIS determine the scope of any proposed policy measures? Should they scope vary based on the policy measure in question or should the scope be the same for all policy measures?

Answer

Q27 How could costs and benefits be measured by the IAIS?

Answer

Q28 How could a materiality threshold be set?

Answer

In seeking to identify sources of systemic risk through industry-wide stress testing, the IAA believes it is important for supervisors to achieve sufficient industry participation and that relevant industry segments for the stress (e.g., bank-owned insurers vs mutual vs stock insurers etc.) are well represented.

Q29 Are there other aspects the IAIS should consider in assessing the implications of ABA work?

Answer

Q30 What impact do you think the ABA should have on the revision of the G-SII Assessment Methodology?

Answer

Q31 Do you have any other comments on the approach taken?

Answer

The IAA thanks the IAIS for this opportunity to respond to this important topic.

In summary, the IAA believes that insurance activity is much less of a source of systemic risk, especially global systemic risk, than is posed by banking activity. Nevertheless, insurance activity has resulted in (and may do so in the future) sources of idiosyncratic systemic risk which require monitoring, identification, policy measures etc. These examples of idiosyncratic systemic risk can pose material risk to a jurisdiction or a local region.

It is the IAA's view that examples of potential systemic risk exposure are more often connected with long-term insurance activity rather than from short-tail general insurance.

The IAA supports the IAIS initiatives to identify, assess and address potential sources of systemic risk resulting from insurance activity. The IAA believes that ABA provides a useful pragmatic tool for supervisors in helping to gather systemic risk exposures. However, the IAA believes that ICP 24 provides the fundamental overall direction to supervisors in this regard and that the connection/linkage of the ABA to ICP 24 should be made clear.

The IAA would be pleased to follow-up (via email, conference call or in person meeting) with the IAIS on any of the points raised in our responses.