



# IAIS

INTERNATIONAL ASSOCIATION OF  
INSURANCE SUPERVISORS

Public

## **Non-traditional Non-insurance Activities and Products**

**25 November 2015**

**Public Consultation Document**

**Comments due by 25 January 2016**

## **About the IAIS**

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions. The mission of the IAIS is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

Established in 1994, the IAIS is the international standard setting body responsible for developing principles, standards and other supporting material for the supervision of the insurance sector and assisting in their implementation. The IAIS also provides a forum for Members to share their experiences and understanding of insurance supervision and insurance markets.

The IAIS coordinates its work with other international financial policymakers and associations of supervisors or regulators, and assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB), member of the Standards Advisory Council of the International Accounting Standards Board (IASB), and partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS also is routinely called upon by the G20 leaders and other international standard setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector.

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## Preface

In July 2013, the IAIS published a framework of policy measures for global, systemically important insurers (G-SIIs), which included a classification table of typical insurance products and activities.<sup>1</sup> The notion of Non-traditional Non-insurance (NTNI) activities and products, and the classification of a list of insurance products, features and activities from across all jurisdictions, forms an integral aspect of those policy measures.

The IAIS acknowledges the importance of sufficient clarity and an improved understanding of the NTNI concept in light of the role it plays in the identification of G-SIIs and the determination of the Basic Capital Requirement (BCR) and Higher Loss Absorbency (HLA) Requirement.

This Consultation Document is intended to solicit feedback from stakeholders on the proposed analytical framework and the preliminary conclusions from the analysis, including how various insurance products and features from across all jurisdictions should be classified. This includes feedback on the selection and completeness of benefit types and liquidity features assessed, as well as the transmission channels through which vulnerabilities could amplify a shock and contribute to systemic risk.

This consultation focuses on features of insurance contracts that may be identified as “non-traditional.” There may be other products and activities that are undertaken by insurers and can be classified as non-insurance. These were envisioned under the original NTNI Principle 3, which captures activities creating “maturity or liquidity transformation, leverage or imperfect transfer of credit risk.” This consultation focuses on insurance product features, while noting that these other products and activities, would still constitute NTNI.

This consultation is the first step of a three-step process to clarify the NTNI concept and its consistent application across IAIS projects and across jurisdictions. The three steps are as follows:

- Step 1: Finalise the analytical framework proposed in this consultation, based on **product features**.
- Step 2: Assess and then classify the list of **products** and activities identified in the consultation against the framework of features, informed by the input provided by stakeholders.
- Step 3: Identify any gaps in or necessary modifications to the framework and existing **principles**, with input from stakeholders as appropriate.

These conclusions will be reviewed in future to capture improvements, developments in the insurance sector, changes in insurers, growth in the global insurance markets and any progress in methods and approaches for measuring systemic importance in the insurance sector.

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<sup>1</sup> See Global Systemically Important Insurers: Policy Measures, 18 July 2013.

## Glossary of abbreviations

BIS	Bank for International Settlements
CDS	Credit Default Swap
FSB	Financial Stability Board
G-SIBs	Global Systemically Important Banks
G-SIIs	Global Systemically Important Insurers
G20	Group of Twenty Countries
HLA	Higher Loss Absorbency
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
NTNI	Non-traditional Non-insurance

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## NTNI Transmission Analysis

### 1. Introduction

- 1.1. On 18 July 2013, the IAIS published the *G-SII Policy Measures*. In this document, the IAIS introduced three principles that guide the determination of whether activities and products could be classified as Non-Traditional Non-Insurance (NTNI) (see Annex 2). That paper also contained a classification table of typical insurance activities and products that were labelled as traditional or non-traditional (this list was illustrative and is still under active discussion). In 2015, the IAIS decided to further clarify the concept of NTNI, analyse the characteristics, features, and risk profiles of a wide range of activities and products across jurisdictions and identify the transmission channels through which they could contribute to systemic risk.
- 1.2. This consultation is the first step of a three-step process to clarify the NTNI concept and its consistent application across IAIS projects and across jurisdictions. The three steps are as follows:
  - Step 1: Finalise the analytical framework proposed in this consultation, based on **product features**.
  - Step 2: Assess and then classify the list of **products** and activities identified in the consultation against the framework of features informed by the input provided by stakeholders.
  - Step 3: Identify any gaps in or necessary modifications to the framework and to the existing **principles**, with input from stakeholders as appropriate.
- 1.3. As part of Step 1, this Consultation Document solicits feedback from stakeholders on the proposed analytical framework, including the principles by which insurance products and features from across jurisdictions should be classified, and the preliminary conclusions from the analysis. This includes feedback on the selection and completeness of benefit types and liquidity features assessed and the transmission channels through which vulnerabilities could amplify a shock and contribute to systemic risk. More specifically, this Consultation Document has two main objectives:
  - To provide further clarification on the concepts of NT and explain how their characteristics drive their systemic relevance<sup>2</sup>.
  - To provide guidance on how to identify NTNI products and activities by matching the NTNI principles with the specific characteristics that they seek to capture.
- 1.4. Steps 2 and 3 will seek to ensure consistency in application across jurisdictions and all measures applying the concept of NTNI. The results of the assessment will be incorporated into the G-SII Assessment Methodology, the Basic Capital Requirement (BCR) and the Higher Loss Absorbency (HLA) Requirement, which are interlinked.
- 1.5. The IAIS has considered a broad range of activities and products from various jurisdictions, including the insurance markets in North America, Europe and Asia.<sup>3</sup>

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<sup>2</sup> The notion of NI is not the primary focus of this paper.

<sup>3</sup> Further detail on the countries and products that will be further examined in step 2 can be found in Annex 1.

This analysis is intended to be as comprehensive as possible, rather than only covering features that the IAIS has previously characterised as non-traditional or traditional.

1.6. The structure of the initial analysis is very briefly as follows:

- Clearly define the elements of the analysis. This is important to ensure a systematic approach and in particular to avoid confusing the causes and the effects of potentially systemic characteristics. The proposed elements (product features, transmission channels and exacerbating factors) are set out in Section 2.
- Analyse, in detail, the characteristics, features, and risk profile of activities and explain the transmission channels through which they may give rise to systemic outcomes, noting any exacerbating or mitigating influences. Specifically, this is intended to demonstrate how certain products and activities could lead to effects that are not contained within the insurer and could potentially have a significant impact on the broader economy.

1.7. In line with the goal of consistent application of NTNI, in subsequent analyses the IAIS will:

- Map the potentially systemic activities and product features onto the existing principles with the aim of identifying any gaps in or necessary modifications to the existing principles.
- Compare the application of the NTNI concept across IAIS projects.

#### *Providing feedback*

1.8. Feedback on this Consultation Document is invited by **25 January 2016**. Feedback received by this date will enable the IAIS to enhance the analytical framework that serves to distinguish traditional insurance from NTNI. The IAIS is seeking answers to the specific questions listed in the consultation as well as on each section of the document.

1.9. Comments are most helpful where they are clear as to the issue being addressed, provide a clear rationale and basis for comments made, and describe alternatives proposed for consideration.

1.10. Comments must be sent electronically via the “Consultations” page of the IAIS website (<http://www.iaisweb.org/>). All comments will be published on the IAIS website unless a specific request is made for comments to remain confidential.

#### *Next steps*

1.11. The IAIS will carefully consider comments from Members and stakeholders on this Consultation Document and will revise the contents proposed within where appropriate. All three steps of this analysis are intended to be finalised in time to be incorporated in the 2016 G-SII designation exercise.

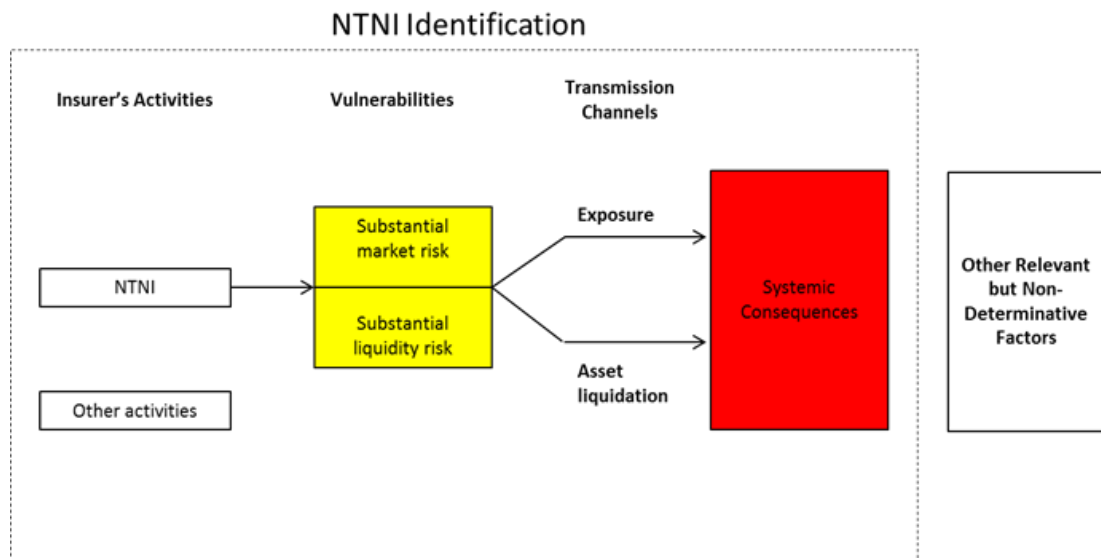
1.12. The broad timetable can be summarised as follows:

	<b>Activity</b>	<b>Date</b>
Step 1	Start of consultation	End November 2015
	Consultation period	Two months until 25 January 2016
	Assessment of comments and review of conclusions	By end Q1 2016
Steps 2 and 3	Initial product assessment and classification (informed by stakeholder input); review of principles	By end Q1 2016, for incorporation in 2016 G-SII designation exercise

## 2. Elements of the analysis

2.1 The analysis undertaken seeks to set out the vulnerabilities that could be created by certain activities and features and the transmission channels by which those vulnerabilities could lead to systemic outcomes, as depicted in Figure 1. Each element depicted is explained in further detail in Sections 2.1 to 2.3 below. The analysis focuses on whether products or activities have characteristics that could contribute to systemic risk.

**Figure 1: Analytical framework**



\*The 'other relevant but non-determinative factors' mentioned above do not directly factor into the classification of NTNI. However, these influences are relevant and could, in practice, affect the systemic impact of a product or activity.

2.2 According to the FSB, IMF and BIS in their 2009 Report to the G-20 Finance Ministers and Central Bank Governors, systemic risk is the potential of "disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences to the real



economy.”<sup>4</sup> More specifically, when applied to insurers, systemic impact can materialize “through contagion (where policyholders or markets consider that similar problems may exist in similar products from other insurers) and financial links (for example, in the derivatives markets) and may have an impact on the broader economy through a failure to make good on promises to policyholders or to engage in new transactions that would foster economic activity.”<sup>5,6</sup>

2.3 The IAIS further determined in its 2013 initial G-SII assessment methodology (the 2013 Methodology) that systemic risk in insurance could be measured by categorizing activities into five categories: (i) NTNI; (ii) interconnectedness; (iii) size; (iv) global activity; (v) substitutability. This paper focuses on the first of these categories.

2.4 This consultation focuses on features of insurance contracts that may constitute NTNI. There may be other products and activities that are more appropriately categorised as “shadow banking” than insurance. These activities were envisioned under the original NTNI Principle 3, which captures activities creating “maturity or liquidity transformation, leverage or imperfect transfer of credit risk.” This consultation focuses on insurance product features, while noting that these other products and activities would still constitute NTNI.

2.5 It is important to note that, classification as “NTNI” is unrelated to the amount of time for which a product feature or activity has existed in a particular jurisdiction. Accordingly, new product features or activities will not necessarily be characterised as NTNI and legacy product characteristics that have existed for many years can still be classified as NTNI based on their risk profile.

**Question 1:** Based on the above characterisation of NTNI, is the terminology “non-traditional” confusing? If so, what might be a better term than NTNI? Additionally, what might be a better term than “traditional” for products and activities that are not NTNI?

## 2.1. Features of insurance contracts

2.6 Features of insurance contracts were previously contemplated under NTNI Principles 1 and 2.<sup>7</sup> The list of features below is intended to be as comprehensive as possible. In combination, these features should cover the vast majority of insurance products sold across jurisdictions.

2.7 Two categories of features are considered: (1) benefit features and (2) liquidity features. These are described with the accompanying varieties to be analysed in the table below. In Section 3, these features are assessed to determine if they could expose the insurer to substantial market or liquidity risk.

Feature category	Feature	Varieties to be analysed
1. Benefit features	Nature of the benefit	Indemnity, covering a particular loss, e.g. theft or medical expenses

<sup>4</sup> See International Monetary Fund, Bank for International Settlements, Financial Stability Board (2009).

<sup>5</sup> See Financial Stability Board (2014).

<sup>6</sup> It is important to note that policyholder exposures, alone, are not considered by the IAIS to be a driver of NTNI classification.

<sup>7</sup> See Annex 2 for the original NTNI principles, as stated in the 2013 *G-SII Policy Measures* document.

		Fixed benefit, e.g. paying a regular distribution to the insured over their lifetime or a lump sum on death or survival to a particular age
		Profit participation, where policyholders share in profits of the insurer
		Unit linked or property linked, where benefit is related to the performance of an underlying fund or set of assets
	Contractual Guarantees <sup>8</sup>	No guarantees provided
		Guarantees on vested benefits, e.g. declared bonuses for participating products or 'ratchet up' features on linked benefits
		Guarantees on future benefit accruals, e.g. interest guarantees or fixed minimum bonus levels
		Credit guarantees, e.g. credit default swaps, financial guarantee or mortgage insurance
	Extent to which an insurer can invest in order to match cash-flows of liabilities (ignoring the use of derivatives <sup>9</sup> )	Significant contractual limitations on ability to match liability cash-flows (e.g. policyholder influence over asset allocation or automatic asset reallocation mechanisms)
		No significant contractual limitations on ability to match liability cash-flows (the insurer has the discretion to invest to match the liability cash-flows)
	2. Liquidity features	Delay in access
Surrender only possible at specific times which the policyholder must nominate at the inception of the policy		
Surrender value available with low delay (on-demand)		
Available upon request with medium delay		
Available upon request with long delay		
Penalties on surrender		No material economic penalties
		Account value less a low economic penalty
	Account value less a high economic penalty	

**Question 2:** Are there any other benefit or liquidity features that should be taken into account in identifying NTNI products and activities?

<sup>8</sup> Note that guarantee, in this context, focuses on explicit minimum benefit guarantees (i.e. those expressly made in the contract) and does not include the implicit assumptions made in product pricing.

<sup>9</sup> The use of derivatives is not considered to be determinative one way or another in classifying a product as NTNI. They may be used for hedging market risks, but in a depressed market, firms' derivative hedging strategies could break down if they are unable to roll over existing positions or set up new hedges. The extra demand from firms with similar products could in addition cause derivative prices to become prohibitively high in a downturn. Furthermore, derivatives do not fully eliminate risk, as the transaction substitutes counterparty risk for market risk, which could manifest at similar times.

## 2.2. Transmission channels and vulnerabilities

2.8 The FSB has broadly defined three channels for systemic risk to flow through: (i) the exposure/counterparty channel; (ii) asset liquidation/market channel; and (iii) the critical function or service/substitutability channel. The IAIS has evaluated these channels and concluded that NTNI activities could most likely contribute to systemic risk through the *exposure or asset liquidation* channels, which are defined as follows:

- Exposure Channel: NTNI activity could allow a shock to spread more easily to other financial institutions or markets where there are direct and indirect exposures of creditors, counterparties, investors or other market participants to the insurer.<sup>10</sup>
- Asset Liquidation Channel: NTNI activities could force an insurer to liquidate assets quickly, exacerbating market movements and contributing to asset price volatility. Such asset sales could impact asset prices and thereby disrupt trading or funding in key markets, potentially triggering losses for other firms with similar holdings.

2.9 Product features that expose an insurer to the vulnerabilities of substantial market or liquidity risk could transmit a shock through the transmission channels and potentially have an impact on the real economy. In particular, a product feature that exposes the insurer to substantial market risk could put pressure on its solvency at the bottom of the market, potentially exposing counterparties to losses when their balance sheets are already strained or necessitating the liquidation of assets into falling markets. Product features that expose the insurer to substantial liquidity risk, if exercised *en masse*, could force the insurer to quickly liquidate assets to meet claims. These sales could result in the insurer realizing losses on illiquid assets and potentially lead to insolvency, exposing counterparties to losses.

**Question 3:** Do the identified transmission channels appropriately capture the ways in which the vulnerabilities could amplify shocks and create systemic risk? What, if any, other channels should be considered?

## 2.3. Other relevant but non-determinative factors

2.10 Outside of the features listed in section 2.1, there may be additional influences that are relevant to the discussion of systemic risk but are impractical to assess objectively. These effects, therefore, do not drive the classification of NTNI, but, in practice, could exacerbate or mitigate the systemic effects.

## 3 Analysis of the vulnerabilities

3.1 This section maps the range of product features against the two key vulnerabilities which have been identified (substantial market risk and substantial liquidity risk). In some cases, supervisory judgement may be required to determine the level of systemic risk posed by a product.

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<sup>10</sup> To be clear, exposure to policyholders is not itself a driver of NTNI classification.

3.2 In its 2011 paper, *Insurance and Financial Stability*, the IAIS noted that insurance relies on the premise of *insurability*, which is defined by several criteria. In identifying NTNI products and activities, this framework focuses on two of them: (1) whether there are a large number of uncorrelated and homogeneous risks (i.e. losses are subject to the law of large numbers); and (2) whether the losses are accidental (i.e. not controlled by the insured).

### 3.1 Exposure to substantial market risk

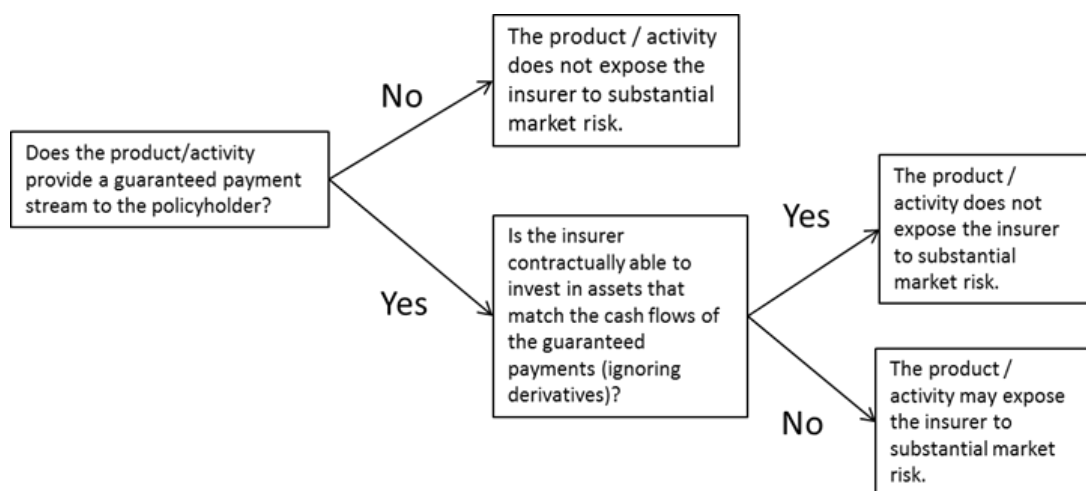
3.3 As a result of the characteristic of insurance that the losses are subject to the law of large numbers, insurers are able to largely diversify away idiosyncratic losses and accurately estimate expected losses across their portfolio. Some activities involve the insurer assuming significant undiversifiable market risk which can lead to problems as the insurer’s losses become strongly correlated with the broader economy and therefore less diversifiable through risk-pooling. Market risk encompasses the risk of losses resulting from movements in market prices and could include, but is not limited to, risks from equity markets, credit markets, and interest rates.

#### 3.1.1 Substantial market risk assessment

3.4 In order to assess how contract features could expose insurers to market risk, a comprehensive set of benefit features is considered. These include the nature of the benefit, the guarantees that apply, and whether the insurer has the ability to invest in assets that will yield cash flows to pay expected claims (ignoring the use of derivatives).

3.5 The assessment of whether a benefit feature could expose the insurer to substantial market risk has two steps. The first step is to identify whether the insurer is taking on market risk in offering the product – which is equivalent to assessing whether a material benefit guarantee applies. The second step is to determine whether the insurer is able to invest the assets backing the guarantee in a manner that matches the cash-flows of the guarantee (ignoring the use of derivatives). This is depicted in Figure 2.

**Figure 2: Simplified illustration of the IAIS’ analysis of exposure to substantial market risk**



**Question 4:** Are these the appropriate two steps that should be used to assess whether a benefit feature could expose the insurer to substantial market risk? What other steps, if any, should be considered in the analysis? Should the two steps be given equal weighting in the assessment of whether a product has substantial market risk? Should the nature of the two step analysis be disjunctive or conjunctive?

3.6 Each of the benefit combinations identified in 2.1 are analysed individually in the table below.

<b>Nature of the benefit</b>	<b>Step 1: Guarantee</b>	<b>Step 2: To what extent can the insurer cash-flow match liability outflows?</b>	<b>Is there substantial market risk?</b>
Indemnity	Not applicable	Claim amounts are unknown <i>ex ante</i> and may be volatile, so assets cannot be invested to match cash-flows.	<p>Indemnity policies provide cover for a specific loss, not a guaranteed value, and thus do not expose the insurer to substantial market risk.</p> <p>Indemnity events are generally uncorrelated with markets.</p>
Fixed benefit	Guarantees on future accruals (such as interest guarantees)	Premiums can generally contractually be able to be invested in fixed income assets that could, in most cases, provide the cash flows required to meet contractual obligations.	<p>Fixed benefit policies with guaranteed accruals expose the insurer to movements in interest rates, and therefore to market risk. These liabilities can generally be cash-flow matched and the assets held to maturity, which reduces the insurer's exposure to market risk to some extent.</p> <p>The resulting correlation of liabilities with the market in tail events is unlikely to be of a scale that would disrupt markets.</p>
Profit participation	Guarantees on vested benefits or future accruals (such as interest guarantees)	<p>In principle, insurers are contractually able to invest to match the guarantees offered, though liabilities may not be matched closely, to allow for bonus accumulation.</p> <p>Policyholder influence over investment decisions may reduce an insurer's ability to invest to match cash-flows.</p>	<p>With-profits (participating) products contain a guaranteed rate of return, and therefore expose the insurer to market risk. However, the products can theoretically be cash-flow matched, reducing exposure to market risk.</p> <p>Liabilities for these products are generally not correlated with the market.</p>
Unit linked / variable annuity	No guarantees provided	Cash flows are matched by construction as the liability is determined by the value of the assets.	Insurers act as an asset manager for policy holders, serving as a pass-thru for investment returns (i.e. the insurer doesn't guarantee

			performance), and are therefore not exposed to market risk through these products.
	Guarantees on vested benefits or future accruals	The prescribed composition of the linked portfolio limits the insurer's ability to invest to match the guarantee. Furthermore, the underlying assets are usually variable in nature, which makes it particularly difficult for the insurer to invest, ignoring derivatives, in order to cash-flow match guaranteed payments.	Losses accrue to the insurer's balance sheet through the guarantee. Furthermore, due to the variability of liabilities, the insurer is structurally constrained in effectively matching asset and liability cash-flows. These products therefore expose the insurer to a high degree of market risk.  The structure of these products leads to a high degree of correlation between the insurer's liabilities and the market, with liabilities greatly increasing in tail scenarios.
Selling of credit protection / mortgage insurance	Guarantees on the value of the reference assets (mortgage, securities or non-traded instruments)	Default events are highly unpredictable, which severely limits the insurer's ability to match cash-flows of claims.	These products guarantee the value of some asset, which exposes the insurer to movements in market prices. Furthermore, trigger events are highly correlated with market cycles and highly unpredictable and can consequently not be cash-flow matched. These products, therefore, expose the insurer to a high degree of market risk.

**Question 5:** Does the list above assess a comprehensive set of benefit features? What, if any, benefit features are not assessed in this section that the IAIS should consider? Do the benefit features listed in this section help provide the IAIS with sufficient information to characterise products and activities as NTNI in a way that applies equally across jurisdictions?

### 3.2 Exposure to substantial liquidity risk

3.7 A key feature of insurability is that losses should be accidental, i.e. not able to be influenced by the insured. Product features allowing for payments that are not triggered by the occurrence of an insured event, such as surrenders or other withdrawals, for example, depart from this definition of insurability and may have features that make them closer in nature to deposits. Products or activities with these features are, therefore, the focus of this section, subject to consideration of the (dis)incentives for early repayment.

3.8 Bank runs are the most commonly cited example of a systemic event. Runs can occur because of a bank's balance sheet profile: liquid liabilities are used to fund long-term, illiquid assets. Because the assets cannot all generally be sold at face value, the position of a depositor in the "queue" to redeem deposits will directly affect the amount

they will receive on their claim. This mechanism provides an incentive to be the first in line, creating a possible dynamic where rational depositors all run based on their expectations of other depositors' behaviour. A bank run can have spill-over effects on the real economy as the run could cause the bank to withdraw funding to productive investment or cause other "healthy" banks to be run on and fail (contagion).

3.9 Insurance, by contrast, is generally known for its strict asset-liability matching. For life insurers, in particular, liabilities tend to be long-term and are generally backed by long-term assets. NTNI classification therefore could also include shorter term liabilities, which expose insurers to liquidity risk that could give rise to a similar dynamic as a bank run.

3.10 Policyholder "runs" are somewhat uncommon phenomena, though there have been several documented cases. Policyholders may have many incentives to run, including: (1) market movements (higher external returns, either interest rates or stock returns could lead to higher lapse rates, while higher internal returns, such as surplus participation, could lead to lower lapse rates); (2) personal financial distress or liquidity concerns; and (3) a general collapse of confidence in a company or product. A number of past runs were due to market changes that made stable value products less attractive. There have also been several runs where policyholders grew concerned about the financial condition of a firm, either through regulatory action or other public knowledge. It is important to note that these experiences did not necessarily have systemic implications. On the other hand, most of the runs occurred during a normal economic environment and it is unclear what effect they would have during a stressed period.

### **3.2.1 Substantial liquidity risk assessment**

3.11 Generally speaking, mass surrenders, withdrawals or terminations should be considered a tail event (albeit with a very large potential impact) for which there appears to be no single trigger event. More likely, a complex interaction between contract features, the state of the insurer, the market environment, individual characteristics and other dynamics will determine the extent to which counterparties have an incentive to surrender. In the interest of arriving at a binary classification of NTNI, it is therefore proposed that a combination of quantifiable factors and supervisory judgement determines the extent to which product features could increase the risk of a run.

3.12 Two key quantifiable factors that the IAIS developed in the 2013 Methodology are (1) the delay in access and (2) the penalties that contracts allow the insurer to apply to counterparties wishing to withdraw. The IAIS quantified these factors for use in the liability liquidity indicator in the NTNI category.<sup>11</sup> This consultation proposes adding a third, judgement-based indicator that is summarised below under the heading of "overriding ancillary factors."

#### **3.2.1.1 Delay in access**

3.13 The more quickly that counterparties are able to access to their funds, the more likely it is that insurers will have to engage in disruptive fire sales of assets to make the payments promised. The longer the delay, the more opportunities insurers will have to spread the sale of assets over time or to access liquidity through other means, such as

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<sup>11</sup> The IAIS is concurrently issuing a consultation paper proposing certain revisions to the G-SII Assessment Methodology.

drawing on credit lines, securitizing assets, or selling lines of business. In addition, a substantial delay in access may create a disincentive for counterparties to surrender their contracts altogether. Taking the assumptions set out in the 2013 Methodology as a starting point, this consultation proposes the following ratings and associated delays in access:

Delay in access	Rating
Less than 1 week	Low (L)
Between 3 months and 1 week	Medium (M)
More than 3 months	High (H)

**Question 6:** Do the proposed time periods appropriately capture liquidity risk?

### 3.2.1.2 Economic Penalty relative to account value<sup>12</sup>

3.14 The larger the legal or contractual costs that counterparties must bear on surrender, the smaller the incentive to withdraw funds. A substantial penalty, by itself, will not remove all surrender risk, as some counterparties may be immune to any monetary disincentive (e.g. in case of panic). Again taking the assumptions set out in the 2013 Methodology as a starting point, this consultation proposes the following thresholds for the costs of settlement:

Economic penalty	Rating
No penalty	Low (L)
A penalty of less than 20%	Medium (M)
A penalty of more than 20%	High (H)

**Question 7:** Other than contractual penalties or taxing requirements, what other economic penalties should be captured? These should be readily quantifiable and generally applicable (i.e. not policy- or policyholder- dependent).

**Question 8:** Do the proposed economic penalty thresholds appropriately capture the monetary disincentives to surrender?

### 3.2.1.3 Ancillary factors

3.15 There is a range of further factors that cannot directly be translated into an *ex ante* monetary economic penalty, but that nevertheless provide incentives or disincentives for surrendering policies. Importantly, the incentive to surrender or maintain a contract could vary over time. Other factors, divided into a narrow and wider set, may include:

*Narrow set of factors*

- Purpose of the policy: policies offering protection to holders serve a different economic purpose than products used as a vehicle for saving, which makes them

<sup>12</sup> As described in the 2013 Methodology, economic penalties include “fees or tax.”



less likely to be seen as deposits. They therefore do not have the same incentives for surrender.

- Surrender value relative to market value: the value of surrendering the policy may be different from the market value of the assets backing it at the time of liquidation, creating an incentive to surrender and earn a premium (or disincentive to surrender and realize a loss).

#### *Wider set of factors*

- Replacement of cover: the risk that policyholder may not be able to obtain coverage or the same amount of coverage for comparable costs.<sup>13</sup>
- The imposition of variable tax penalties on surrender of tax advantaged products.<sup>14</sup>
- Loss of guarantees: the policyholder may forfeit any guarantees associated with the policy, such as guaranteed interest rates or guaranteed minimum living/death benefits.
- Flexibility to lower policy surrender values: a lower benefit on surrender may deter policyholders from forgoing the future benefits of the policy.
- Policyholder protection schemes: unlike the other points listed above, this does not relate to the contractual features of a product. However, if policyholders are confident that they will still be paid if an insurer is placed in disorderly run-off, they may have less incentive to run. This factor may therefore also be of relevance in some cases.

3.16 It is important to note that contract features, including (but not limited to) premium structure, remaining time in force and fee structure, may also exacerbate or mitigate surrenders, though these more microeconomic considerations are not feasible to take into account for a broad classification as NTNI.

**Question 9:** Are the above factors relevant to insurers' exposure to liquidity risk? How might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms?

**Question 10:** What other considerations might be relevant to insurers' exposure to liquidity risk? Should these be incorporated into the framework as ancillary factors? To this end, how might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms?

### **3.2.2 Assessment guidance**

3.17 Combining these factors, the following guidance with regards to the classification of products is proposed:

<sup>13</sup> While dis-incentivising surrender, this may in some cases exacerbate any solvency issues due to adverse selection.

<sup>14</sup> In case this is not already accounted for in the economic penalties

Combination of delay and penalty ratings	Preliminary classification	Overriding ancillary factors
LL (Low, Low)	Presumed to expose the insurer to substantial liquidity risk, where the narrow set of overriding factors do not apply	A narrow set of factors, including whether (1) the contract principally offers a protection (mortality or morbidity) benefit <sup>15</sup> or (2) whether the surrender value is less than or equal to market value of the backing assets at the time of liquidation
Any other combination	NTNI classification subject to the absence of the narrow set of factors and supervisory judgement based on a wider set of overriding factors	A wider set of factors, as outlined above
HH	Presumed to not expose the insurer to substantial liquidity risk	N/A

3.18 Products in the LL category would therefore be classified as NTNI, unless at least one of the narrow set of factors applies. In addition to the narrow set of overriding factors, classification of products with a combination of L and H would further be subject to the wider set of factors.

**Question 11:** For those products with both protection and savings components, how should the distinction most clearly be drawn between those that resemble deposits and those that do not? Which considerations should be included in the narrow and the wide sets of ancillary factors?

**Question 12:** How should the IAIS think about the liquidity risk of products that combine savings and protection benefits? Does the proposed approach appropriately reflect the potential liquidity risk on such products or would there be a better way to address this?

<sup>15</sup> Examples of such products include but are not limited to whole-of-life (whole or ordinary) life assurance or disability insurance policies.

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## 4 Other relevant but non-determinative factors

4.1 Outside of the insurance contract features listed above, there may be additional factors that are relevant to the discussion of systemic risk. These factors do not drive the classification of NTNI but, in practice, could affect the systemic impact. While these factors are non-determinative for the purposes of NTNI classification, they can be relevant for consideration as part of Phase III (the Discovery Phase) in the process for the Identification of G-SIIs (for more details see the G-SII Assessment Methodology Consultation Document). These factors include, but are not limited to:

- The use of derivatives per se is not sufficient for a product/activity to be categorized as NTNI. However, insurers could use derivatives to hedge market risk that they cannot diversify away, suggesting that derivative usage could be an indication of NTNI activity. In a depressed market, firms' hedging strategies could break down if they are unable to roll over existing positions or set up new hedges. In a downturn, the extra demand from firms with similar products, could in addition cause derivative prices to become prohibitively high. Furthermore, derivatives do not fully eliminate risk, as the transaction substitutes counterparty risk for market risk, which could manifest at similar times.
- The lack of suitable assets could exacerbate the risk embedded in certain products. For example, in the recent low interest rate environment, certain fixed benefit or annuity policies have exhibited a substantial duration gap, i.e. there are not sufficient quantities of long-tenor assets to match liabilities. As a result, insurers are exposed to reinvestment risk where they have had to resort to investing in shorter-tenor assets and rolling over the positions when the assets mature. In many jurisdictions, insurers have to carry out rigorous cash flow testing to test their ability to pay claims as they come due. Many insurers use a range of stochastic and deterministic scenarios to test these parameters in various stress situations – beyond the normally expected payment of claims. This testing may better prepare for periods of stress.
- Insurers may have tools at their disposal to mitigate the impact of market risk on particular contract features. Some firms have contractual ability to adjust premiums when guarantees are in the money. While such instruments could limit the transmission of a market shock, they could possibly have unintended consequences by creating a fear among policyholders that they will not have access to their funds and triggering higher lapses and surrenders.
- To the extent that an insurer has invested in liquid assets, this may mitigate some of the effects of a forced asset liquidation. If faced with sudden liquidity demands, the insurer may be able to sell assets, even in a stressed market, without significantly impacting prices. However, if the insurer has a significant shortage of liquid assets, then it may be forced to sell assets at a loss, potentially exacerbating market movements in a stressed environment, or failing to meet claims.
- In addition, some supervisors are able to reduce the value of guarantees associated with in-force business, which could reduce the pressure on the firm's solvency.

**Question 13:** Recognising that they are not determinative, what other factors might influence insurers' exposure to market or liquidity risk?

**Question 14:** Should these factors be taken into account as determinative in the NTNI classification? To this end, how might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms? To what extent, if any, do these factors allow for the consistent application of the NTNI concept across jurisdictions?

## 5 Conclusion

5.1 The analytical framework described above sets out the basis for classification of insurance-like products and activities as NTNI. It focuses on insurance contract features that could make an insurer more vulnerable and transmit shocks in such a way that could have an effect on the real economy. Those features that expose an insurer to substantial market risk or liquidity risk could amplify shocks and create systemic risks either through the exposure of counterparties or the procyclical liquidation of assets.

5.2 Product features are assessed using a two-step framework to determine if they expose the insurer to substantial market risk: (1) whether the product includes a guaranteed benefit; and (2) whether the insurer has the ability to invest in assets that match the cash-flows required to pay the benefit. Product features that have a guaranteed benefit and for which the insurer does not have the ability to invest in assets that will yield sufficient cash flows to pay off expected claims (ignoring derivatives), could expose the insurer to substantial market risk and therefore be classified as NTNI.

5.3 Product features that could expose the insurer to substantial liquidity risk are also assessed using two factors: economic penalty and delay in access. Those features or activities that allow counterparties to withdraw funds with a low delay (on-demand) and with no additional economic penalty will be presumed to expose the insurer to substantial liquidity risk, except if the product or activity is principally providing protection (mortality or morbidity) or if the surrender value is less than or equal to the market value of assets backing the policy. Products with a high delay (proposed to be more than 3 months to access) and high economic penalty (proposed to be greater than 20%), would be presumed to not expose the insurer to liquidity risk. Products or activities not falling into either of those groups would be assessed using a wide set of ancillary factors to determine if they expose the insurer to substantial liquidity risk and could therefore be classified as NTNI.

5.4 Products or activities not captured by this analysis of insurance contract features could still be classified as NTNI if they result in maturity or liquidity transformation, leverage or imperfect transfer of credit risk.

**Question 15:** Is the list of products and activities set out in Annex 1 representative of the insurance activities and products that are conducted in the listed jurisdictions? Are there other products and activities that should be added to the list, for example because they have similar features as those in Annex 1? To what extent, if any, will the analysis of the products and activities in Annex 1 allow for the consistent application of the NTNI concept across jurisdictions? Also, are there additional or alternative terms for the listed products and activities that should be added to improve the completeness and clarity of the list?

**Question 16:** In light of your response to this Consultation, to what extent, if any, should the IAIS revise the existing NTNI Principles to allow for the consistent application of the NTNI concept across jurisdictions? To what extent do the three Principles help inform the IAIS' common understanding of what products and activities should be classified as NTNI? Please explain your answer.

## References

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## **Annex 1: 2015 List of Representative products/activities for IAIS assessment**

**This Annex does not pre-judge whether these products and activities should be classified as traditional or non-traditional. This list contains some products, product features and activities that will – following the assessment - not be classified as NTNI.**

The July 2013 G-SII Policy Measures Paper included a table (Table 1, p.17) classifying a number of typical insurance activities or products as Traditional or Non-Traditional (see Annex 2). Annex 1 is intended to expand the list of activities and products for analytical review and public consultation by the IAIS. In addition to the products and activities listed in the 2013 G-SII Policy Measures Paper, the IAIS also will analyse the products and activities listed in Annex 1. The objectives of the analytical review and consultation by the IAIS are to clearly understand the important characteristics of each activity and/or product (including standard or typical contractual provisions, as well as the risks they may present to the insurer) and to better understand the differences in these products among the various country-specific markets. The list of products and activities is intended to be representative of the insurance activities/products that are issued or conducted in each jurisdiction (where applicable) by insurers in that jurisdiction (both domestic and foreign insurers).

The IAIS will consider the following FSB jurisdictions: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Spain, Switzerland, Turkey, the United Kingdom, and the United States.

<b>Selected Activities/Products/Features (not pre-judging the classification)</b>
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Certain types of Property and Casualty/Liability Insurance
Credit Insurance/Financial Guarantee
Fixed death benefit/endowment
Fixed indexed annuities
Guaranteed investment contracts/Funding agreements
Guaranteed savings products
Certain types of Health Insurance
Participating/with-profits policies with guaranteed rates of return
Retirement annuities
Variable annuities/unit-linked products with or without guarantees

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## Annex 2: NTNI Principles (excerpt from G-SII Policy Measures document)

**Principle 1:** *Products that provide credit guarantees to financial products such as securities, mortgages and other traded or non-traded instruments - whether principal or interest - can be considered NTNI.”*

*Explanation: Even though the idiosyncratic parts of the credit risk may be readily diversifiable, insurers providing such coverage are nonetheless vulnerable to systematic risk and therefore vulnerable to shocks that affect the entire economy or that otherwise tighten correlations. The guaranteed debt is often dispersed throughout the economy, and the impairment of the value of the guarantee of the debt instrument due to the distress or failure of the insurer could result in a severe impact on the economy. When credit guarantee or coverage is short-term in nature then the exposure to systematic events is limited. Such products could be considered traditional.*

**Principle 2:** *Policies or products that expose the insurer to substantial market and liquidity risk and require a more complex risk management practice by the insurer in order to hedge those risks and may require substantial, complex, and dynamic use of derivatives, can be considered NTNI.”*

*Explanation: The complexity of the risk management necessary to handle such risky products exposes insurers to sizeable market and liquidity risk, increases the potential for modelling errors, makes them more reliant on over-the-counter derivatives markets and increases their interconnectivity through the greater volume of transactions. This creates the potential for fire sales or pro-cyclical hedging strategies. The decision to hedge complex risks, while desirable from a micro-prudential perspective, in turn increases the interconnectedness of the respective insurer, thus making it more dependent on functioning derivatives markets.*

**Principle 3:** *Investment and funding or other capital market activities that result in maturity or liquidity transformation, leverage or imperfect transfer of credit risk, such as repo and securities lending, beyond that justified by the scope and scale of conducting traditional insurance activities, can be considered NTNI.”*

*Explanation: The categories of traditional, non-traditional and non-insurance also apply to investment activities, whether on balance sheet or off. The degree to which investment activities involve the points of concern mentioned in this principle and the extent to which they support traditional insurance business will determine their classification as NTNI.*

*This principle addresses concerns identified by the FSB’s analysis of shadow banking. It aims to capture those activities that can increase leverage, increase risks from proprietary speculation, reduce transparency from investments in private pools of capital, and make the insurer more reliant on the trading and funding liquidity of capital markets.*