GRF Response to the IAIS Consultation on "Global Systemically Important Insurers: Proposed Updated Assessment Methodology"

(Submitted 25 January 2015)

The Global Reinsurance Forum (GRF) would like to thank the IAIS for the opportunity to submit a response to this Consultation Document on the Proposed Updated Assessment Methodology for Globally Systemically Important Insurers. The GRF is composed of twelve leading global reinsurers; its main objective is to promote a stable, innovative, and competitive worldwide reinsurance market. The members of the GRF, all private companies, are Gen Re, Hannover Re, Lloyd's, Munich Re, Partner Re, Renaissance Re, RGA, SCOR, Swiss Re, Toa Re, Transatlantic Re, and XL Catlin.

The GRF is strongly opposed to the proposed supplemental assessment for reinsurance activities. Reinsurance is already included in the quantitative (Phase II) assessment – this is in our view already questionable given that there is no evidence that "traditional" reinsurance is source of systemic risk. This conclusion is shared by the IAIS in its report "Reinsurance and Financial Stability" dated 19 July 2012, in which the IAIS concludes "traditional reinsurance is unlikely to cause, or amplify, systemic risk." Despite this conclusion, the IAIS proposes to include reinsurance as the one and only activity to be evaluated by means of a dedicated supplemental assessment in addition to a quantitative indicator.

We would like to reiterate that reinsurers act as absorbers and therefore mitigators of risk on a global scale. In the absence of evidence of systemic risk attributable to individual reinsurers, the IAIS would be better suited omitting the reinsurance supplementary assessment and focusing its efforts on activities that have been shown to cause or amplify systemic risk.

That being said, we appreciate that the IAIS seeks to make use of absolute reference values for some indicators. Absolute reference values that are derived from aggregate market data and/or industry market share appear to be a better indicator of the level of systemically-risky activities than relative values based on the sample of insurers in the designation exercise, whose business volume may not be representative of the overall market for these activities. However, more clarity about the concrete deployment of reference values by IAIS would be needed prior to have a final view on this issue. In particular, for the reinsurance indicator, the absolute reference value should reflect the prevailing consensus that reinsurance activities do not contribute to systemic risk given the current market composition.

Finally, the GRF agrees with the IAIS findings as published in "Insurance and Financial Stability," November 2011, that insurers contribute to systemic risk if at all through NTNI activities. Therefore, we advocate increasing the weight of the NTNI category in the designation, and decreasing the weight of interconnectedness. Moreover, we advocate that the "interconnectedness" category be strictly applied to measure the **non-insurance** interconnectedness of insurance groups with the financial sector (including but not limited to insurance companies). Insurance and reinsurance interconnections do not add to, but mitigate systemic risk.

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

Absolute reference values that are derived from aggregate market data and/or industry market share appear to be a better indicator of the level of SRAs than relative values based on the sample of insurers in the designation exercise, whose business volume may not be representative of the overall market for these activities. However, more clarity about the concrete deployment of reference values by IAIS would be needed prior to have a final view on this issue. Of the three activities for which absolute reference values are proposed, Reinsurance has never led to a systemic event, which is a fact that should be taken strongly into consideration for the setting of the absolute indicator. Therefore, the absolute reference value for the reinsurance indicator should reflect the prevailing consensus* that reinsurance activities do not contribute to systemic risk given the current market composition.

In general, the methodology for designating G-SIIs should identify and assess the extent of SRAs carried out by G-SIIs. In setting the threshold for a specific SRA, the decisive question should be, "how much of this activity can be allowed to fail until (due to direct consequences or via amplification) significant disruption is caused?" This is the critical amount of SRA. In this manner, reasonable absolute reference values for selected indicators can be introduced. In some cases, it may make sense to express the critical amount of SRA as a percentage of the total amount of the activity in the market. This is especially true if the relative importance of the activity for the well-being of the global financial system and economic activity does not change.

* see the IAIS report “Reinsurance and Financial Stability” dated 19 July 2012

***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.*

Given the conceptual consistency of using absolute reference values the IAIS should explore the use and availability of such values also for other indicators, e.g. "Derivatives" and "Level 3 assets" in the "Interconnectedness" category. As stated by the IAIS in Section V paragraph 30 of the consultation, "the G-SII identification process focuses on how an insurers failure or distress would impact the global financial system, not the probability that an insurer will experience failure or distress." Since investments in derivatives and level 3 assets are carried out by the entire financial sector, the absolute reference values based on the overall market size for these investments should be used. For derivatives, the Bank for International Settlements provides robust market statistics for both exchange-traded and OTC derivatives. The IAIS should consider the current exposure to a derivative counterparty adjusted to reflect legally-enforceable netting (e.g. – via ISDA agreements) and collateral arrangements.

***Question 3**: What information or data could be used as an absolute reference value for the financial guarantees indicator?*

The proposed approach seems appropriate for lack of a more suitable alternative.

Question 4: *Is structured finance bonds insured an appropriate denominator or should the denominator reflect the notional value of bonds guaranteed by the broader financial sector via non insurance products?*

A clear definition of structured finance bonds is required. Since these activities are not necessarily contained in the insurance sector, the denominator should reflect the notional value of bonds guaranteed by the broader financial sector via non-insurance products.

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?*

We believe the BIS statistics on the overall global CDS market are an appropriate indicator. The absolute reference value should reflect the fact the systemic risk can only emerge when an individual market participant achieves a significantly high market share, such that the risk of contagion in the event of default is high and/or the participant is no longer substitutable in the event of a sudden inability to provide the services.

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?*

Our clear preference would be to drop this indicator from the list. Reinsurance should be incentivised as a stabilising factor to the financial system rather than penalised. Ideally, the measure should be based on primary insurers' exposures to reinsurance and the "share of wallet" of the reinsurer regarding the ceded risk from the primary insurer.

If for data availability reasons global reinsurance premiums are to be used as absolute reference value, we would support this, but in that case we would expect to place this indicatorin 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. (Consider for example a reinsurer with a premium income of 1% of the global insurance premium. Then its scoring should be based on this 1% market share.) 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.

* see the IAIS report "Reinsurance and Financial Stability" dated 19 July 2012

***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?*

We agree that this indicator reflects incoming risks that reflect the probability that an insurer will be in distress, rather than the systemic risk from an insurer's failure and therefore support the removal of this indicator.

***Question 8**: To what extent, if any, are intra-group commitments an appropriate measure of a potential G-SII's systemic relevance?*

We support the removal of this indicator. The consultation proposes using intra-group commitments to provide relevant information on an insurer's NTNI activities, however we believe that the NTNI framework should be appropriately robust so that an analysis of intragroup commitments is not needed for this purpose.

***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?*

Derivatives trading (excluding hedging and replication) potentially impacts the probability that an insurer will be in distress, but may or may not necessarily impact the systemic risk from an insurer's failure. This depends on the scale of activities carried out by the individual reinsurer relative to the overall market. The IAIS should consider the current exposure to a derivative counterparty adjusted to reflect legally enforceable netting (e.g. – via ISDA agreements) and collateral arrangements.

***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.*

In line with IAIS findings * any attempt to tackle systemic risk in the insurance sector must clearly focus on the extent and the potential impact of NTNI activities. Even if the assessment methodology is attributing the highest weight to NTNI, the other categories –most notably interconnectedness– still have significant impact on the outcome of the quantitative assessment. We doubt, however, the high weight interconnectedness is given within the assessment methodology. It is true that a systemic banking crisis would have a strong impact on the insurance industry, which can be a source of systemic risk. However negative spillovers are mainly transferred from the banking sector to the insurance sector, not vice versa.

In light of these considerations, we strongly recommend to increase the weight of the NTNI category in the designation, and decrease the weight of interconnectedness.

* see the IAIS report “Insurance and Financial Stability” dated November 2011

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.*

The notional value of derivatives does not reflect the true underlying risks. Instead, the IAIS should consider the current exposure to a derivative counterparty adjusted to reflect legally enforceable netting (e.g. – via ISDA agreements) and collateral arrangements.

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?*

In general, we welcome any efforts of the IAIS to use market-level indicators, as these are a better indicator of systemic risk than using indicators whose denominator is taken from the potential G-SII sample.

Short-term funding indicator: Further, the short-term funding indicator should be improved to focus only on funding activities that may lead to systemic risk. In particular, the indicator should exclude securities lending activities where the cash collateral from the repurchase agreement or securities lending transaction is reinvested in liquid, high credit quality assets, and if the security lent or put out on a repo is sufficiently liquid.

Level 3 assets indicator: The IAIS argument that there may be a fire sale of these assets seems exaggerated in the context of creating systemic risk. In considering the potential for Level 3 assets to pose a risk of fire sales, it is important to consider the duration of the liabilities that they are matching and whether policyholders have the ability to surrender. We also refer to the very strict prudential regulation of assets under various local regulatory regimes.

Liability liquidity indicator: (Re)insurance claims are much slower than claims on banks. Large insurance claims are often paid after a thorough assessment of losses and therefore may take several years to be settled. The slow pace of failure increases substitutability by providing the time required to rebuild industry capital and capacity. The only potential risk addressed by this indicator involve potential cancellation clauses, as addressed in the IAIS consultation document on NTNI activities and products from November 25th, 2015.

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?*

The IAIS criteria for data collection focus primarily on size. It should be noted that systemic risks may be caused by market participants irrespective of their individual size, as, for instance, the Savings and Loan crisis has demonstrated. Nonetheless, the proposed criteria seem to be a pragmatic approach and we would therefore not propose any changes or additions to the criteria.

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?*

The quantitative threshold should be set in such a way as to ensure that only insurers in Group 1 (above the threshold) may be potential sources of systemic risk. Consistency and annual stability, though worthwhile goals, should be secondary considerations. See also our response to Question 15 below.

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?*

GRF strongly supports the use of cross-sectoral analysis. IAIS should compare the profiles of potential G-SIIs with systemically important firms in other sectors – in particular for interconnectedness and NTNI activities. It would be appropriate for the threshold for insurers to be set at a comparable level to the GSIB threshold. In particular, potential G-SIIs who are candidates for Group 1 (above the quantitative threshold) only due to scores in activities which are comparable with potential G-SIBs (derivatives, turnover, level 3 assets, derivatives trading, short term funding) should be removed if potential G-SIBs with similar or higher business volumes in these activities were not deemed systemically relevant.

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?*

We have strong concerns regarding the application of a qualitative phase (see as well our response to Question 17 below). Should a qualitative phase nonetheless be desired, and assuming the process satisfies the characteristics laid out in our response to question 17 below, we would advise the IAIS to use this phase to evaluate and recognize

- the quantity and quality of the financial strength of the company
- quality of risk management and the use of company specific capital models (if any)
- the existence of severe local/regional regulatory regimes in place.

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?*

In general, a qualitative phase that exposes potential G-SIIs to subjective judgement should be set up in such a way as to ensure objective, consistent, comparable and transparent treatment of all potential G-SIIs. The consultation document so far does not provide adequate assurance that this will be the case. Firstly, the process must be designed in such a way as to ensure balanced and comparable value judgements – this can potentially be accomplished by ensuring that a committee consisting of the same members evaluates each potential G-SII. These members must also represent a viewpoint that in aggregate is reflective of the consensus view regarding sources of systemic risk in insurance. The challenges of setting up such a process that fulfills these requirements should not be underestimated. We have strong reservations regarding the degree to which such a process is practical or even feasible and would advise the IAIS to forgo the use of a qualitative phase unless it can provide a more detailed proposal for a process that meets these minimum criteria. Should the IAIS choose to go forward with the qualitative phase, it is critical that IAIS introduces concrete mechanisms to determine the potential impact of the qualitative analysis on the G-SII designation. We would propose that the qualitative phase ultimately be used to determine a multiplier which is applied to the score for the relevant indicator from phase II. This multiplier should be limited by a lower and upper bound of no greater than +/- 20%. That is, the qualitative phase can result in an increase or decrease of the score for each indicator by up to 20%. This framework, coupled with a fair and balanced judgement process, would ensure that the process is consistent and comparable while not exposing individual potential G-SIIs to excessive subjective judgement. Note also that this response applies as well to the Reinsurance Supplementary Assessment (see our response to Question 19 below).

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

No further comments.

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 I? If so, what should be the level of the threshold?*

We have serious concerns regarding a separate process for reinsurance activities, as there is no evidence that classical reinsurance is a source of systemic risk. This conclusion is shared by the IAIS in its report "Reinsurance and Financial Stability" dated 19 July 2012, in which the IAIS concludes "traditional reinsurance is unlikely to cause, or amplify, systemic risk". Even in the case of a hypothetical reinsurance failure, primary insurers would be affected only to a limited extent, as only a small share of the total insurance premium is ceded to reinsurers. Reinsurance activities may include retrocession or co-insurance. However, the timing of claims payments and the limited size of an insured loss event would prevent a systemic crisis, even if reinsurers unwittingly accepted back risks as inwards reinsurance that they had ceded to other reinsurers beforehand (hypothetical "reinsurance spiral"). No systemic risk arises from underwriting catastrophe losses (natural catastrophes, man-made catastrophes, even pandemic events), either. Furthermore, a major event – as experienced in previous catastrophes – does not generate immediate massive cash outflows.

In our view, the right way to determine whether there is any systemic impact from the reinsurance activities of a failed reinsurer is: look at the exposure the primary insurers have in terms of reinsurance liabilities to the failed reinsurer, and determine whether it would have a critical impact on the primary insurer if those liabilities would not (or not fully) be fulfilled.

However, we do suggest that the IAIS should set an absolute threshold for the determination of whether a (re)insurer is subject to completing the supplementary reinsurance-specific questions (e.g. 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?*

See our response to question 21 below.

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?*

Based on our experience, industry-wide stress testing is the only reliable method for evaluating the potential systemic risk caused by reinsurance. That is, one must analyze the aggregate exposure of the primary insurance industry to reinsurance in the event of severe but plausible stresses. In particular, for any given provider of reinsurance, one must analyze the impact of a default on the post-stress excess capital throughout the insurance industry. This has been carried on an aggregate basis by the IAIS in its report "Reinsurance and Financial Stability" dated 19 July 2012. The IAIS concludes that "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." The results can be duplicated on a wider sample by carrying out the same analysis using the 2014 EIOPA stress tests. Such analysis is sensible and insightful, but at the same time costly not only for the IAIS but also for participating re/insurers. Nonetheless, we are fully convinced that this is the only reliable method for determining whether any particular reinsurer poses systemic risk to the broader financial system.

Question 22*: Are an insurer's third-party reinsurance activities interconnected with financial markets and, if so, how? What additional data measures could be useful to understand the extent to which an insurer's third-party reinsurance activities are interconnected with other parts of the financial markets (e.g. banks or asset managers)?*

With the exception of some credit reinsurance lines, reinsurance activities are not interconnected with other parts of the financial markets. There is no difference between potential interconnectedness with financial markets between insurers and reinsurers. In addition, financial risks for reinsurance activities tend to be lower than for primary insurers since assets used for matching reinsurance liabilities tend to be more readily available than for many primary insurance products. Any interconnectedness with financial markets should be captured in Phase I and II for both insurers and reinsurers. With regards to credit reinsurance lines, this business should be recognized in the "financial guarantees" indicator of Phase II of the assessment.

Question 23*: What other data points would be relevant for the IAIS to consider in the Proposed Methodology when evaluating the extent to which the potential geographic risks (i.e. the risk that a reinsurer or insurer may be overly concentrated in one area) of the global reinsurance market are dispersed or concentrated among certain reinsurers or insurers?*

The reinsurance market is global in nature and a significant portion of reinsurance business is cross border. For example, even if a single reinsurer is concentrated in a particular geographic region, substitutability in this region is not lower than in other regions since capacity can be made available cross border in short notice. No definition of "area" i.e. country, region, jurisdiction, is appropriate in this global context. The focus of all analysis in the context of reinsurance should be on "global" systemic relevance.

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

The insurer should be given the opportunity to present its own analysis and argumentation regarding its systemic importance. The process should allow sufficient time for the prospective G-SII to prepare this analysis. For this, the IAIS should provide its preliminary assessment to the prospective G-SII in advance of the exchange, ensuring that potential G-SII is provided sufficient time to provide an adequate response. Should a qualitative assessment be carried out by the IAIS, then those individuals who carried out the assessment should be present to hear the case made by the potential G-SII and potentially revise their assessment accordingly.

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?*

The allocation for HLA purposes should be assessed and communicated to the potential G-SIIs as soon as possible. Therefore, it is reasonable to base the initial allocation on the initial G-SII assessment of Phase II. However, 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. Thus, any changes in scores in Phases III and IV should be taken into account when definitely assigning the G-SIIs to their HLA buckets.

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?*

The stability of the G-SII-list is not a value in itself that needs to be protected. However, changes due to temporary factors (like currency fluctuations) should be avoided. Insurers should have incentives to exit the G-SII list by reducing potentially systemically relevant activities at the earliest feasible opportunity.

Question 27*: How and, if so, to what extent should conceptual aspects of the Proposed Methodology, including , the data instructions, the data template, and the detailed formulas used for the calculation of indicator scores be made publicly available? If made publicly available, who should disseminate this information? What factors should the IAIS consider in this respect?*

We strongly urge the IAIS to be fully transparent regarding the conceptual aspects of the proposed methodology. The data instructions, data template, quantitative thresholds, and detailed formulas used for the calculation of indicator scores should be made publicly available. In particular, transparency on formulas used for the calculation of indicator scores enable G-SIIs and potential G-SIIs to more effectively reduce their systemically risky activities which lead to their designation.

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

All re/insurers in the assessment should be informed of their scores immediately following Phase II. Also, if re/insurers are added by discretion of the relevant authorities despite falling below the threshold, then they should be informed well in advance. They should be provided sufficient time to prepare their own analysis before making their case in the "Exchange with prospective G-SIIs" phase (see our response to Question 24 above). For this, it is critical that potential G-SIIs are given enough information on the methodology to be able to reproduce their own scores. Furthermore, GRF believes that for transparency purposes, IAIS should think of providing to all assessed companies at least in an anonymous way the distribution of the individual scores of the whole sample of (re-)insurers.

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?*

We advocate against making data used for the calculation of the scores and the resulting scores available to the public. This information is not publicly available and is not available for all publicly traded insurers.