



# International Association for the Study of Insurance Economics

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## THE GENEVA ASSOCIATION RESPONSE TO THE IAIS PROPOSED METHODOLOGY FOR DESIGNATING G-SIFIs IN INSURANCE

### BRIEFING PAPER

The following paper provides a précis of The Geneva Association's response dated 31 July 2012 to the IAIS consultation paper, *Assessment Methodology for the Identification of Global Systemically Important Insurers*, issued 31 May 2012. The document has been drafted in consultation with The Geneva Association's members and is intended as a summary of selected key points of the GA submission rather than the whole document.

#### **Introduction**

The Geneva Association and the wider insurance industry have been supporting the ongoing regulatory initiatives set in motion by the G-20 to increase the resilience of the global financial system. **We believe that the development and promotion of effective supervisory and regulatory policies to reduce systemic risk and address information gaps is for the benefit of all concerned, including the insurance sector.**

**The traditional insurance business model is fundamentally different to that of banks.** Insurance pools risks and uses probability theory, including the law of large numbers, to manage risks; insurance liabilities are prefunded through policyholder premiums; it has a predominantly liability-driven investment approach using asset liability management tools; the nature of insurance claims or policyholder benefits results in outflows over an extended period of time with liabilities that are illiquid and not subject to surrenders and others only callable with explicit or implicit disincentives for the policyholder. This timing element is a fundamental feature of insurance that allows companies to resolve in an orderly manner usually over long periods of time. Insurers do not provide systemically relevant financial services such as the payment system or credit intermediation. These differences are not recognised in the proposed indicators however; four of the five indicator categories used in the methodology are the same as those used for banks.

Our research has shown that the most efficient and appropriate means of identifying and tackling systemic risk in insurance is to focus on activities rather than institutions as a whole—see our research report [Considerations for Identifying Systemically Important Financial Institutions](#) (April 2011). The Geneva Association has identified two activities that have the potential to create systemic risk as defined by the FSB's criteria, namely speculative derivatives trading on non-insurance balance sheets and the mismanagement of short-term funding. When collecting data for this methodology, focus should be given to companies engaged in potentially risky activities.

**Traditional Insurance.** Geneva Association research, in particular the research report [Systemic Risk in Insurance](#) (March 2010) has demonstrated that traditional insurance activities do not create systemic risks. Comments from the IAIS, for example in Section A of the consultation paper and the financial stability paper of 16 November 2011, indicate an acceptance of this fact. However, traditional insurance features prominently in the indicators. **The inclusion of traditional insurance activities in the methodology is likely to detract from an effective analysis and could result in non-risky insurers being designated as systemically risky and systemically risky insurers avoiding designation.** The Geneva Association recommends removing traditional insurance from all indicators where appropriate.

**Total Size and Global Activities.** Paragraph 8 of the IAIS consultation discusses the size of an insurer and concludes, *“The risk profile of an insurer becomes less risky the more risks are assumed, i.e. the larger it is and the more diversified its business is (the more lines of business it writes).”* We have long argued this point and wholly agree. However, the methodology ascribes up to a 20 per cent weighting to size and global activity. Since size determines some other indicators explicitly, it reaffirms the statement made in the paragraph above calling for the exclusion of traditional insurance, since it is the traditional business which predominantly drives the size of an insurer. Otherwise companies would be highly ranked simply based on their size.

**Interconnectedness.** **It is not clear why the weighting of interconnectedness in insurance (30-40 per cent) is higher than it is in banking (20 per cent) nor why this weight should be appropriate.** It is particularly surprising given that interconnectedness in banking is considerably more intense than it is in insurance, as recent experience demonstrates. This is not the case in insurance, not least because there is no similar mechanism to the inter-bank market in insurance. The weighting of insurance interconnectedness should therefore be significantly reduced.

**Large Exposures.** Insurers fulfil an important role as long-term investors. The current inclusion of traditional insurance activities in the “large exposures” indicator could lead to a change in insurers’ current asset allocation and thus impede governments to finance their debts, as insurers would reduce their investments in sovereign bonds. Further, the effect of these policy measures for systemic risks must also be coordinated closely with other overlapping regulatory initiatives such as Solvency II to avoid any unintended collateral effects.

**Comparability.** The Geneva Association highlights that comparing the results only within the defined industry universe would potentially overstate the importance of the top-ranked insurers compared to other players of the financial service industry. The Geneva Association suggests therefore that results from the indicators be compared against the whole financial services industry where possible rather than just the universe of selected companies. **An artificial delimitation especially of financial activities that are not specific to our industry from those of other financial services providers is not appropriate.**

**Reinsurance.** Reinsurance acts as a source of stabilisation for insurance and financial markets as it permits the redistribution of primary insurance risks. This point is acknowledged in the 19 July 2012 paper from the IAIS, [Reinsurance and Financial Stability](#), Paragraph 14 thus, *“Reinsurers contribute to the global diversification of risks and to an efficient allocation of capital and improved risk management on the side of primary insurers.”* It is also discussed in Paragraphs 15 and 16 of the IAIS paper and in the methodology in Paragraph 33 where interconnectedness is cited as its reason for inclusion. One possible impact from this indicator could be that a reinsurer would reduce their assumption of business, thus reducing their diversification potential and at the same time increasing the reinsurer’s probability of failure. Reinsurance should be removed from the list of categories.

**Substitutability.** In The Geneva Association reports, [Systemic Risk in Insurance](#) (April 2010) and [Key Financial Stability Issues in Insurance](#) (July 2010), we showed that insurance products are substitutable. A catastrophic event can cause the insurance industry to reassess the pricing of its products. This has historically led to higher premium levels. New premium levels may be, in the worst case, prohibitive for customers who refuse to bear the cost but this situation is not systemically risky. Insurers are not involved in systemically relevant financial services, like banks, where immediate substitutability is required, i.e. the payment settlement system and the provision of credit facilities. A breakdown of hours or days in the payment system provoked by the failure of a bank would have dramatic systemic consequences, whereas a lack of coverage of one of the three insurance business lines mentioned in the indicators would be very unlikely to have the same immediate consequences. In the unlikely event of its occurrence, governments can temporarily intervene as has happened in the past without causing systemic disruption.

**The Supervisory Assessment Process.** The Geneva Association supports the proposal to give enhanced supervisors an important role in this process; however we would like to see that role more specifically described. This includes better and more specific description of the activities captured in the different buckets of the IFS approach. As the IFS approach concurs better with the activities-based approach than the indicator-based approach we would like to understand from the IAIS how the result of the IFS approach would correct a poor ranking from the indicator approach. These more local

regulators would ensure that decisions are made in consultation with a body familiar with the company under discussion. Furthermore, as the current resolution process in most jurisdictions enables insurers to fail in an orderly way, we strongly suggest making this an important mitigating factor in G-SII designation. We recommend that candidate company management are involved as early as possible in the assessment process to avoid any misunderstandings or misreading of data and permit companies to demonstrate how they are managing PSRAs. Finally, the supervisory assessment process should also enable a company, its Board and Management to undertake transactions with a clear understanding of how it may affect its current status—for example, whether mergers, acquisitions or disposals will affect their ranking. An as early as possible involvement of the management of a candidate company would enable to discuss up-front risk-management policy and avoid misunderstandings and misreadings of data collected.

**Policy Measures.** Any potential policy measure resulting from this process should reflect the drivers of systemic risk and create the right incentives for companies to manage them appropriately. We also agree that progress needs to be made on the resolvability of IAIGs and support the current work IAIS is undertaking (ComFrame).

### **Concluding Comments**

While the original philosophy behind the methodology as expressed in the IAIS's November 2011 and in the May consultation paper is sound, we highlight in our submission the areas where the outcome of the current methodology might be adjusted or improved for the benefit of all concerned.

The system must make the best possible use of regulatory capacity by focusing on activities that can create systemic risks and not misallocate capacity and resources on areas that do not.

We believe that traditional insurance activities should be removed from the process and that non-insurance activities be given a higher weighting than they are currently.

We would also caution that more consideration should be given to any possible unintended consequences that could arise for the insurance sector as well as for the wider economy from measures that will change *inter alia*, the investment incentives, the competitive landscape and underwriting practices of our industry.

Our full response to the IAIS on each category is available at:

[http://www.genevaassociation.org/PDF/Insurance And Finance/GA2012 Response to IAIS Consultation-July.pdf](http://www.genevaassociation.org/PDF/Insurance%20And%20Finance/GA2012%20Response%20to%20IAIS%20Consultation-July.pdf)

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