Re: IAIS Higher Loss Absorbency capacity for G-SIIs Consultation from 25 June 2015

Dear Mr. Kawai,

The Institute of International Finance (IIF) and the Geneva Association (GA) welcome the opportunity to provide comments on the International Association of Insurance Supervisors (IAIS) consultation document dated June 25, 2015 on the Higher Loss Absorbency (HLA) capacity for Global Systemically Important Insurers (G-SIIs). The joint IIF/GA HLA Working Group, which is comprised of a wide range of insurance firms, appreciates the work the IAIS has put into this Consultation Document.

This letter details a number of general comments of the joint IIF/GA HLA Working Group that we would like to share with the IAIS in regards to the HLA proposal.

In summary, a number of members disagree with the proposed methodology, and believe it is too blunt a tool, built on still uncertain foundations and that the entire G-SII framework as currently proposed does not provide appropriate incentives for systemic risk mitigation.

We would note in particular:

- HLA should focus on systemic risks and activities that contribute to or amplify such risks;
• the current HLA proposal is based on moving targets;
• a necessary link between non-traditional and non-insurance (NTNI) activities and (systemic) risk still needs to be demonstrated;
• HLA calibration is disproportionate and unlikely to contribute to financial stability; and,
• the BCR + HLA is a blunt capital requirement and may provide ambivalent incentives to de-risk.

We expand on these points in more detail below.

We regret that it has not been possible to respond to the questions posed in the Consultation Document, as the variables in the proposal affect individual insurance firms in very different ways.

• **HLA should focus on systemic risks and activities that contribute to or amplify such risks**

In July 2013 the Financial Stability Board (FSB) and IAIS clarified the objectives of the G-SII policy framework, particularly regarding distress and failure. We believe that in order to achieve these objectives the G-SII policy framework should focus on activities that contribute to or amplify systemic risk to the global financial system. An activities-based approach was also the focus of recent FSB and International Organization of Securities Commissions (IOSCO) communications regarding Non-Bank Non-Insurers¹ and we believe that such an approach would be relevant in insurance as well. Such an approach would also ensure a level playing field with asset management and regulated banking activities as the HLA would only apply to systemically risky insurance activities and all other activities are appropriately considered under the respective sector’s systemic regulation. Importantly, a focus on activities would provide an incentive for the reduction of systemically risky activities.

As proposed, the HLA capital add-on may be based on the entire insurance group balance sheet. By broadening the HLA’s scope to all insurance activities, the ‘size’ criterion in the G-SII methodology as applied to entities is given inappropriate weight. This does not align with the insurance business model, where increases in business portfolios are a common risk management strategy to diversify risk profile and/or prevent loss due to risk concentration.

• **The current HLA proposal is based on moving targets**

The Working Group unfortunately finds itself in the situation that it cannot fully assess the HLA proposal’s impact on the insurance sector as two key components of the proposal, namely the G-SII assessment methodology and NTNI definition, are subject to future consultations.

The process of G-SII recognition (and de-recognition) is currently unclear and under review by the IAIS; this lack of clarity will fundamentally influence the bucketing of individual firms. Similarly, the review of NTNi could affect the use of the gamma parameter to weight HLA to NTNI. This introduces significant

variables that hold the potential to materially alter the capital requirement outcomes set by the proposed HLA. Indeed certain members feel strongly about the unaddressed critical elements and would want to seek a delay of the HLA proposal until this uncertainty is completely resolved. Furthermore, the timing for HLA development and finalization does not allow G-SIIs to conduct sensitivity analysis of the options in the HLA proposals.

We understand the desire of the IAIS to present an HLA proposal at the G20 meeting in November 2015. However in this context we believe the HLA development process would benefit greatly from a firm commitment to fully re-examine the proposal once clarity is achieved on these underlying moving parts. The Working Group is concerned that endorsement by the G20 at the Antalya summit will give any ‘temporary’ proposal undue regulatory weight. The most effective HLA framework will be one that is flexible enough to make any required changes as and when more information is available on these key theoretical foundations.

- **A necessary link between NTNI activities and (systemic) risk still needs to be demonstrated**

There is a presumption that activities on the current NTNI list would have a systemic impact on the global financial system and thereby automatically merit a capital add-on. However we believe that there is insufficient evidence to support the link between certain activities currently defined as NT or NI to systemic risk.

It is imperative that any methodology distinguishes between non-insurance and non-traditional activities, and which of those activities increase (systemic) risk. Non-insurance activities (such as CDS underwriting) are likely to have quite different risk characteristics and should receive greater scrutiny or a higher risk weighting than non-traditional activities.

The IAIS could consider the transmission mechanisms that could lead to a systemic risk to the global financial system from the distress or failure of an insurer undertaking such activities. Such analysis will also help insurers to manage their impact on the system. The magnitude of activities also needs to be considered in the context of the market for such activities, and the insurer’s balance sheet as a whole.

- **HLA calibration is disproportionate and unlikely to contribute to financial stability**

Calibration targets for HLA need to be relative to the level of systemically risky activities undertaken. G-SIIs are generally far less systemic than Global Systemically Important Banks (G-SIBs) given the nature of their business model. The IAIS and the FSB recognize that traditional insurance business does not give rise to systemic risk and that insurance groups do not pose the same level of systemic risk as banks (for whom the full balance sheet may be systemically risky). The proposed calibration targets are therefore far too high and do not reflect the differences between banks and insurers.

- **The BCR + HLA is a blunt capital requirement and may provide ambivalent incentives to de-risk**

The Basic Capital Requirement (BCR), on which the HLA will be founded, is necessarily insensitive to risks due to its factor-based nature. The proposed uplift would amplify the BCR’s inherent weaknesses (for example insensitivity to portfolio diversification and asset / liability management) and could lead to
unintended effects and pro-cyclicality. It would also prove a significant challenge to manage business under metrics which will not act in the same way or in the same proportion under different market conditions and can lead to conflicting management incentives.

In addition, the assessment of HLA capital levels based on a relative ranking of G-SIIs against their peers under the assessment methodology may have adverse effects on individual firms (which has also been raised by the industry during the development of the G-SII assessment approach). When a firm’s HLA level is determined not only on its own activities, but by the ranking of those activities relative to those of other firms, de-risking of the individual firm may not lead to a decrease of its HLA capital add-on. When all firms de-risk at the same time, individual capital levels may remain the same. On the other hand, if one firm completely de-risks, other firms may be imposed a disproportionate capital add-on. As a result, the level of capital required could be volatile and inconsistent in application.

The Working Group is strongly committed to continuing constructive dialogue and cooperation with the IAIS. Given the number of critical issues highlighted and given the wide range of views by our participants, the Working Group members believe that a direct dialogue with the industry is essential and appreciate the IAIS’s willingness to continue those interactions.

The IIF and GA stand ready to provide additional views or clarifications. Should you have any questions on the issues raised in this letter, please contact the undersigned.

Andres Portilla

Anna-Maria D’Hulster

CC: Svein Andresen, Financial Stability Board