INSURANCE COMPREHENSIVE RISK FRAMEWORK

1. Approach to the framework

1.1. The holistic framework strategy

An official explained that IAIS is close to completing its project. It has developed and consulted on the framework, which has been strongly encouraged by stakeholders and in discussions with the FSB. The approach recognises the specific nature of the insurance business model. IAIS has a different approach to the banking sector and asset management sides, recognising that insurance activities are not inherently seen as systemic, but insurers nevertheless engage in activities and build-up exposures that could be systemic in the collective.

IAIS has ended up with a holistic approach in the sense that it recognises systemic risk can come from collective activities and exposures in the insurance sector, but that does not mean it is completely devoid of an entities element. Recognition is needed that those activities and exposures can be more concentrated in particular entities. Consequently, IAIS needs to continue to monitor and respond to that build-up at the entity level.

Entities-based approaches (EBA) and activities-based approaches (ABA) target similar exposures, but the risks that are propagated differ. EBA is a systemic impact given default effect; the ABA looks more at the collective build-up, which leads to systemic risk. Both sides need to be examined in a holistic way and recognise that both types of propagation can exist. It is also holistic as it is moving away from the previous binary approach, which had prescribed predetermined policy measures applied to a narrow list of a few insurers.

The examination also looks at activities and exposures more generally and applies policy measures in a proportionate way, which are targeted to a broader section of insurers, informed by activities and exposures, rather than starting with the entities themselves. This general direction has been strongly supported in stakeholder comments; a holistic framework that is properly and consistently implemented provides a better approach to systemic risk in the insurance sector than a G-SII (Global-Systemically Important Institution) approach. The IAIS focus is on consistent implementation.

A regulator noted that the holistic framework does not want to simply be a set of policy measures. It wants to be a framework for action and co-ordination between the supervisory authorities to detect any building up of systemic risk as soon as possible and assess whether those threats are being properly addressed. A part of the framework tries to integrate the current supervisory material of IAIS by introducing ongoing policy measures that should mitigate sources of systemic risk. There is also integration of supervisory material by adding a toolkit for supervisors, which has a number of powers of intervention that could be used when necessary and the circumstances require it.

The rest of the framework comprises a monitoring part at the level of the IAIS, which should complement the monitoring of national supervisors. That has the purpose of gathering all the information that is necessary to detect any building up of systemic risk at an individual and sector-wide level as soon as possible.

The other element is how information gathered from this monitoring could be rationalised and interpreted by a joint assessment of national supervisors. In the collective assessment phase national supervisors should make their national assessment a global assessment in order to detect global systemic threats, and also to be confident that those potential systemic threats are known and being addressed properly.

Collective framework ensures consistency of application of the policy measures, but its main purpose is to make all supervisors aware of the level and trend of global systemic risk and to have confidence that national supervisors are taking care of those threats. The final component of the framework is the implementation assessment. There should be an exercise at the IAIS level to check how individual jurisdictions apply the ongoing policy measures and any powers of intervention.

A regulator supported combining or extending the old systemic approach, by including the broader perspective of sector-wide activities and the behaviour of insurance companies. The whole framework will enhance the management of risk of the companies, ICPs and ComFrame.

Proportionality is key. Not every measure is to be extended to every firm, but only if there is a need to address certain firms that engage in certain activities and fulfil certain criteria. What is missing are papers on the application at a different level, which will follow in the second step.

There is a lot of common ground with the European approach, and the global and EU frameworks are covering similar risks, transmission channels and perspectives.

A regulator summarised that the framework is well designed. There is a general recognition of the need to assess the build-up of systemic risk from both the industry and the supervisory community. Following an approach specific to the insurance sector goes against the approaches used in banking. Commonality and consistency are needed between micro and macro supervision, as well as integrated frameworks. One of the distinguishing characteristics when comparing insurance to banking is the need to have a holistic framework which goes beyond individual assessment and has more horizontal view of the activities that may pose a threat to financial sustainability. Proportionality is key, which is also widely recognised. Success depends on implementation and how the supervisors will work together.

1.2. Key success factors to benefit from the implementation of the framework

An industry representative stated that the EIOPA paper released in March 2019 is a good framework for discussion on whether a macroprudential framework is needed.

Their company's core business is long-term in nature and its investment strategy tends to be risk-averse, so it considers the insurance industry to have a limited source of systemic risk. Therefore how the framework is implemented is very important. In particular a cost/benefit analysis of the framework is needed before it is implemented. It remains to be demonstrated that the added value outweighs the cost.

The fact there would be an application of proportionality is positive, as the private sector felt that is a critical success factor. Drastic measures such as resolution should only be applied where there is demonstrable evidence that material risks to the global financial system exist.

If macroprudential supervision is needed for insurance, then it should be tailored for insurance. Within that, consideration is needed on leveraging some existing tools. The Solvency II framework already requires the private sector to consider short-term and long-term risks, which provides support for both a micro-prudential and a macro-prudential view.

An industry representative stated that their company has had a good introduction to the holistic framework. One of its most positive aspects is its renewed emphasis on macroprudential surveillance, which the company strongly supports. The representative stressed that the real measure of risk is how an activity is managed, not whether it exists or not.

The success of a holistic framework is the ability to identify, address or mitigate the effects of the next systemic crisis. Annual quantitative data is good as a baseline, but the goal of systemic risk management needs an assessment through a systemic risk transmission channel lens. The two traditional channels of systemic risk that are relevant to the insurance sector are: analysing what makes a party think there is an asset-liquidation risk, and what it could lead to for counterparty exposure.

Critical services to the functioning of capital markets can largely be put aside for the insurance sector.

A regulator felt that the advantages largely outweigh the shortcomings and the costs. Most ongoing policy measures that will be integrated in the supervisory material are not new. More detailed and enhanced policy measures are trying to include good practices in risk management. Appropriate management of liquidity risk, which is one of the most substantial aspects being dealt with, are already – or should be – part of risk management of the companies.

Some National Supervisory Authorities have spent a lot of time doing a gap analysis between the current rules and what should be a regulatory framework that can address systemic risk. It is integrating certain policy measures that have a micro purpose. They are there to reduce the probability of failures of the companies and to protect the policyholders. In doing that, companies should also reduce the probability that these exposures lead to certain externalities in the case of shock. Respective processes should be cost-efficient for the majority of companies.

An industry representative explained that the key is for the emphasis not just to be on annual quantitative data, but rather a forward-looking analysis of the new and emerging risks and trends. Historically insurance was only a small component of most financial crises.

1.3. Combining macro and micro, global and domestic and quantitative and qualitative elements

An official explained that this is an integrated framework, every element of which is needed for it to work effectively as a whole.

Supervisory policy measures form the pre-emptive part of the framework, which are requirements on insurers that should help with mitigation. That should be 80% of the framework. If insurers have proper risk management in place, then these activities and exposures should not have the potential to become systemic in the first place. The famous example of AIG was more of a problem of risk management than anything else. This was not an additional cost because these are things that insurers should be doing anyway as part of good risk management. IAIS's global monitoring exercise builds from supervisors' own macroprudential surveillance at a jurisdictional level.

There is then a quantitative IAIS data exercise. Quantitative and qualitative analysis is needed to achieve various objectives. The first is to check that the policy measures have been an effective mitigation. It is also necessary to see whether there are trends or a build-up in potentially systemic activities and exposures. In addition, there is also a forward-looking part, which is where the qualitative aspect is more important. Indeed, an important element of the overall risk framework is to identify the emerging risks that need to be looked at. Thus, a global response to concerns is needed, as systemic risk in the global insurance sector is at a global level and is a global problem. A consistent and collective response to systemic risk is a key success factor.

The current framework has micro-prudential requirements, but some of them automatically give private companies some macroprudential governance, surveillance and supervision. Another Solvency II example is long-term guarantees. There is volatility and a matching adjustment, which in some respects goes to the macroprudential part of Solvency II. A regulator noted that in Europe the 2020 Solvency II review could include some macroprudential elements.

An industry representative believed that those questions are for IAIS and EIOPA, as the proposals refer to bringing both elements together. The question from the private sector is how IAIS and EIOPA envisage that happening. For private companies the consideration is more on how IAIS and EIOPA will leverage the pieces that already exist.

1.4. Interaction between Insurance Distribution Directive (IDD) and the framework

A regulator stated that he had not heard of a deep analysis of that. Care is needed to ensure that the outcome is not that the only systemic risk in insurance is conduct risk.

A regulator felt that this is an interesting question because market conduct issues could lead to some kinds of systemic impact. IDD should work by mitigating any market conduct issues in the lack of credibility of the overall insurance system or generalised mis-selling of products. Depending on the size of those phenomena, some issues may need to be addressed at the national level, but possibly also at the global level.

2. Envisaged tools

2.1. The tools to use for identifying risk and coordinating the response

A regulator explained that the framework is based on monitoring and its quality is key. It is there to detect any build-up of systemic risk, but nobody knows what the source will be of any future crisis that threatens financial stability. The monitoring system should be efficient but also wide in detecting any possible concentration at both market and individual levels of exposures that could lead to systemic risk. It takes into account inward risks, which are risks from the wider economy that could impact insurance, and outward risks that the insurance or financial sector could bring to the economy.

The collective assessment has the purpose of determining a coordinated response, which could be based on different types of tools. The system has the advantage of being flexible in its supervisory intervention. If used properly that is an advantage of the system, because the supervisor will be able to use the right tools for certain situations. The main shortcoming is that it depends on the behaviour of supervisors and companies and is not only a question of the design of the framework.

Regarding costs, it is important not to overburden the companies with data collection. Current data collection is focused on individual companies, but the focus is on integrating that with market-wide data collection. This must be cost-efficient and based on data that supervisors already have at their disposal.

2.2. Liquidity risk requires particular attention at both macro and micro levels

An industry representative stated that there is a need to focus on systemic risk transmission channels, liquidity being the principal one that regulators should focus on. In the US, the National Association of Insurance Commissioners (NAIC) has launched a macroprudential initiative, the key component of which is a liquidity risk framework and liquidity stress-testing. They have identified 23 of the most relevant insurers who will be required to do periodical liquidity testing. This is consistent with what all insurers in the US above a certain level have to do with their own risk and solvency assessment (ORSA).

At a micro-prudential level every company should have an ORSA that identifies key liquidity risks and makes sure they have all internal controls in place. If any of those risks materialise, their response should already be identified. The NAIC will have baseline scenarios that insurance companies will be able to demonstrate periodically for whatever area they are focused on across the sector.

2.3. Should discussion of capital be included in a macroprudential framework?

A regulator believed the 'elephant in the room' is removing individual specific designations in the whole approach. Everybody who is interested in getting off the list should encourage everybody else to implement the holistic framework as much as possible.

An industry representative felt the starting point for this intervention could be using the right tool to properly identify and address the risk.

Private companies need to start building up capital. If a company is a money-centred bank then they are systemic, and resilience and capital buffers make sense. However, insurers are also trying to address asset liquidation, exposure concentration through limits that they already have in place. Through ORSAs insurers can demonstrate to the regulators if they are sectoral, geographical or even counterparty exposures. Insurers do a lot of work on that, and the industry should be proud of that. Consequently, the added measures being discussed here would be a cost that is not worth the benefit.

The next aspect that private companies will see is the preventative measures in June. The IAIS will come up with improvements to ComFrame, ICPs, and liquidity risk management. Their company is comfortable with that, but the trend that is causing worry comes from accepting the transmission channels of liquidity or asset sales, and then concentration risk. Discussion is needed about the right tools to go with those types of risks.

An official noted that insurance is different from banking. There is recognition that capital is not a good first stop when dealing with systemic risk in the insurance sector, which is different from the G-SII approach and HLA (Higher Loss Absorbency). The G-SII framework is currently still in existence and will only be replaced by a holistic framework once there is credible implementation. A temporary capital add-on in the optional regulatory toolbox is not a recommended regulatory tool, but potentially could be one. Omitting that from the toolbox would signal that temporary capital add-ons were never a solution to systemic concerns, which the IAIS was not prepared to state.

A regulator asked panellists whether discussion of capital should be entirely ruled out when it comes to a macroprudential framework. All panellists agreed that there should be no discussion of capital in that context.

An industry representative noted there is an important role for capital to play in every solvency system. Micro and macro should be integrated because similar risks are often looked at from a macro perspective. Outside the insurance sector, all the work that has been done on derivatives is one of the most important areas where insurance potentially has systemic relevance.

A regulator agreed, but believes it depends on what kind of capital charge is being spoken about. A permanent capital charge could be disregarded but could not be ruled out as being a useful intervention tool.

2.4. Next steps and finalisation

An official stated that if everything goes according to plan then the framework will be adopted in November 2019 for implementation in January 2020. If the FSB is comfortable with the proposed holistic framework then it has agreed in November 2019 to suspend the G-SII identification. It will make a final decision on whether to completely remove the G-SII framework in November 2022 based on the experience of the IAIS and its member supervisors' consistent implementation of the framework.

A critical part of the overall success is consistent implementation of the framework. The IAIS has said it will have a robust implementation assessment process over 2020 until November 2022 to encourage the consistent implementation of the framework. Following that there will be an annual cycle of the global monitoring exercise, looked at from quantitative and qualitative perspectives.

Regarding next steps, the IAIS will publish things in the middle of June. The first will be resolved comments on the consultation document that had been released in November last year, but also a new consultation for public comment that will outline a specific drafting of the ICPs and ComFrame to give effect to policy measures being proposed. IAIS also aims to provide an update on other aspects of the framework such as the global monitoring and implementation assessment sides. There will be a comment period until August and then an intensive period in IAIS over September and October to finalise the proposals, discuss them with the FSB, and build the FSB's endorsement of that approach.

A national regulator believed that work is needed on bringing the holistic framework through. Implementation is key, and the next step to take. In Germany, BaFin is committed to contribute to very intensive implementation, but it does not mean that everybody will be ready on the first day. Everybody will take time to adjust to the framework, to assess what has already been implemented and where changes will be necessary. Proportionality is key. The FSB is expecting IAIS to deliver and it is committed to doing that.