Insurance comprehensive risk framework

Jonathan Dixon

Secretary General, International Association of Insurance Supervisors (IAIS)

Towards a holistic framework for systemic risk in the insurance sector

Introduction

The International Association of Insurance Supervisors (IAIS) has consulted on a proposed holistic framework for the assessment and mitigation of systemic risk in the insurance sector.

The proposed framework is holistic in the sense of:

- Recognising that systemic risk may arise from both the collective activities and exposures of insurers at a sector-wide level, as well as from the distress or disorderly failure of individual insurers;
- Addressing cross-sectoral aspects of systemic risk, by comparing the potential systemic risk stemming from the insurance sector with other parts of the financial system; and
- Moving away from a binary approach in which certain additional policy measures are only applied to a relatively small group of insurers (based on a list of identified global systemically-important insurers (G-SIIs)), to an approach with a proportionate application of an enhanced set of policy measures targeted at the exposures and activities that can lead to systemic risks from the insurance sector as a whole.

Finalising the holistic framework

Over the course of 2019 the IAIS will finalise the details of the holistic framework. This includes:

Supervisory policy measures and powers of intervention: The proposed set of enhanced supervisory policy measures (which provide the pre-emptive part of the framework, designed to help prevent insurance sector vulnerabilities and exposures from developing into systemic risk) and supervisory powers of intervention (which enable a prompt and appropriate supervisory response where a potential systemic risk is detected) will be translated into IAIS supervisory material (revised Insurance Core Principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)). The ICPs establish the minimum requirements for effective insurance supervision and apply to all insurers on a proportionate basis, whereas ComFrame sets additional standards focusing on effective group-wide supervision of large, >>>

>>> internationally active insurance groups. The draft revised supervisory material will be published for public consultation in June 2019. This will include guidance for supervisors on application of the proportionality principle. It will also demonstrate the link between macroprudential surveillance, the supervisory framework and powers of intervention.

Global monitoring framework: The IAIS will further develop the details of its global monitoring framework, designed to detect the possible build-up of systemic risk in the global insurance sector, including an individual insurer systemic risk assessment methodology and a sector-wide monitoring approach. The IAIS monitoring will complement the macroprudential surveillance by national supervisors. Collectively, this analysis is aimed at supporting a forward-looking conversation within the IAIS on trends and developments, and a coordinated supervisory response to any identified build-up of global systemic risk.

Once the IAIS has finalised the holistic framework in November 2019, the Financial Stability Board (FSB) will assess the IAIS' recommendation to suspend G-SII identification from 2020.

"In November 2019, the Financial Stability Board will assess the IAIS' recommendation to suspend G-SII identification."

- JONATHAN DIXON

Implementing the holistic framework
Implementation of the holistic framework will begin in 2020. Supervisors will be expected to implement the enhanced set of policy measures and supervisory powers of intervention contained in the ICPs and ComFrame. To ensure a globally consistent application of these policy measures, the IAIS will undertake a robust and transparent assessment of implementation. The details of the IAIS' assessment approach will be finalised during the course of 2019.

In November 2022, the FSB will, based on the initial years of implementation of the holistic framework, review the need to either discontinue or re-establish an annual identification of G-SIIs by the FSB in consultation with the IAIS and national authorities. ●

Dimitris Zafeiris

Head of Risks and Financial Stability Department, European Insurance and Occupational Pensions Authority (EIOPA)

Micro- and macro-prudential supervision – going beyond blurry lines

The need to supplement the micro-prudential approach with the macro-prudential approach is one of the main lessons learned from the financial crisis. While the potential systemic risk originating from the insurance sector is less prominent than in the banking sector, the recent work of the European Insurance and Occupational Pensions Authority (EIOPA) suggests that there are indeed instances in which systemic risk can be originated in or amplified by the insurance sector. This poses relevant policy challenges in terms of the interaction between the micro- and the macro-spheres, potential feedback loops and potential tensions that supervisors and other authorities should duly consider.

For example, a certain triggering event may initially impact one or several undertakings. This would require a micro-prudential policy response to ensure that these companies recover or can be resolved in an orderly manner. Under certain circumstances, however, the institution(s)' specific distress may end up creating systemic risk in a negative feedback loops if, for example:

- The number of institutions affected reaches a critical share of the >>>

>>> market, or if the institutions affected are considered systemically relevant - entity-based sources of systemic risk.

- As a reaction to the shock, undertakings engage in certain activities or products that are more prone to create systemic risk - activity-based sources of systemic risk.
- Undertakings start behaving collectively in a way that exacerbates market price movements, such as fire sales - behaviour-based sources of systemic risk.

The potential feedback loops are not one sided. They can go in a bottom-up or outward direction, i.e. from institutions, to the market as a whole but could also have a top-down, or inward direction, where the materialization of systemic risk for example coming from the banking sector will directly or indirectly affect insurance undertakings operating in a relevant market.

In such a context, the distinction between micro- and macro-prudential supervision becomes blurry and tensions between the two approaches may potentially arise. Coordination and cooperation between the micro- and macro-authorities is necessary to avoid potential conflicts.

"Consistency and coherence of micro- and macro-prudential policies is essential to ensure the stability of the financial system."

\- DIMITRIS ZAFEIRIS

This cooperation - not always sufficient - must therefore go beyond the national level. And here EIOPA has a crucial role to play, particularly through its interaction with the European Systemic Risk Board (ESRB) but also with other international organisations such as the International Association of Insurance Supervisors (IAIS) and Financial Stability Board (FSB).

The policy response should avoid focussing on defining strict border lines between the micro- and macro-approach and whether a crisis affects one or more individual institutions, or the market as a whole. Considering the complexity of risks, feedback loops and the potential tensions, consistency and coherence of micro- and macro-prudential policies is essential to ensure the stability of the financial system. The 2020 review of the Solvency II Directive and the potential inclusion of macro-prudential tools and measures is an opportunity not to be missed. ●

Joseph L. Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife, Inc.

Global monitoring: a forward-looking perspective

MetLife welcomes the significant policy shifts in the November 2018 IAIS Holistic Framework consultation document that will help better identify, analyse, and mitigate potential systemic risk in the insurance sector. The new IAIS approach focuses on what activities could generate asset liquidation risk or counterparty exposure, which is more consistent with how insurers manage risk. We support the IAIS intention to update ComFrame and the ICPs to incorporate best practices in risk management related to the transmission channels of asset liquidation and counterparty exposure. We do have a few remaining concerns, however, such as the lack of clarity about what intervention powers are appropriate and the continuing assumption that an activities-based approach fails to address a domino-type propagation of risk.

In our view, even with the appropriate policy measures in place, the main challenge for the Holistic Framework going forward is whether it can fulfil an essential function: the early identification of potential build-up of systemic risk on a cross-sectoral basis. Even if supervisors have the right policy tools to manage systemic risk, it is essential that the IAIS as a global standard setter obtain the "complete picture of the development of risks and trends in the insurance sector," which is referenced in the consultation document.

There is no better way to prevent or mitigate the impact of a financial crisis than by having an effective surveillance mechanism in place that acts as an early warning system. For this reason, we suggest that the global monitoring exercise described in the consultation document rely less on the analysis of annual quantitative data and more on the creation of a first line of defence against a next crisis. We were very encouraged by FSB Chair Randall Quarles' inaugural speech, which lays out a vision for an FSB focus on identifying new vulnerabilities through a framework that benefits from insights from private and public stakeholders across the financial sector, including industry, regulators, and relevant official bodies. In addition to the IAIS building out their own macroprudential surveillance capabilities, we support and recommend the IAIS to take a proactive role in the FSB's cross sectoral surveillance activities. This would require the IAIS to not solely rely on annual data. Instead, they could use their analysis of quantitative data as a starting point for a much more thorough, qualitative inquiry that includes a fulsome dialogue with the private sector to help detect market trends that create new risks or add to current risks in a cross-sectoral context.

"There is no better way to prevent a financial crisis than surveillance that acts as a warning system."

\- JOSEPH L. ENGELHARD

The most effective systemic risk policy tool for the IAIS would be a macroprudential surveillance capacity that can identify the build-up of liquidity or counterparty risk and proactively contribute to a cross-sectoral global monitoring exercise to prevent or mitigate the next financial crisis. ●

Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IVASS)

Systemic risk holistic framework: key factors for success

In November 2018, the International Association of Insurance Supervisors (IAIS) published for consultation a holistic framework for the mitigation of systemic risk in the insurance sector. With this framework the IAIS proposes to evolve the approach to mitigating systemic risk, which is currently based on the application of a predefined set of policy measures to a cohort of insurers (G-SII) that are identified based on their systemic footprint. The new framework considers both individual and collective sources of systemic threats and applies mitigating measures to a wider range of insurers, proportionate to the systemic relevance of those sources.

In summary the key elements of the framework are:

- a set of policy measures for macro-prudential purposes to help prevent risk exposures from developing into systemic threats;
- a monitoring exercise by the IAIS to detect the possible build-up of systemic risk in the insurance sector at a global level, capturing, as far as possible, cross-sectoral aspects;
- a set of supervisory powers of interventions that should enable a prompt response by national supervisors to possible systemic threats;
- a mechanism, based on a collective assessment of global systemic risk at the IAIS level, to help ensure a consistent application of the policy measures and any intervention at jurisdictional level;
- an assessment by the IAIS of the consistent implementation of the entire framework across jurisdictions.

The above elements also identify the main challenges for the proposed framework. Its success will depend on the following factors:

- how national supervisors will apply the measures to mitigate the sources of systemic risk and, in particular, how they will use the discretion left by the framework to identify the scope of application of these measures and to calibrate the intensity of their application, proportionate to the risk exposure;
- how capable the global monitoring exercise by the IAIS will be to promptly detect potential systemic threats, both at individual-insurer and sector-wide level. This means, in particular, how effective and proportionate the data collection and analysis will be and how prompt, clear and coordinated the identification of supervisory responses will be;
- how national supervisors will make use of their own macro-prudential monitoring and the collective assessment at the IAIS when applying the policy measures and deciding if and which supervisory intervention should be taken;
- how effective and transparent the collective assessment at the IAIS will be in identifying global systemic threats and supporting appropriate and consistent responses by national supervisors.

"Its success depends on how supervisors will apply it and their ability to work together."

- ALBERTO CORINTI

Finally, with regard to all the above factors, it is paramount that the implementation assessment process of the IAIS will be effective in supporting an appropriate and consistent implementation of the holistic framework.

The finalization of the framework is a unique occasion to endow the insurance sector with a systemic risk mitigation regime that is consistent with the financial sector supervisory approach, but also tailored to the specificities of insurance. Its success, however, does not depend so much on the design of the regime, but, more importantly, on how supervisors will apply it and their ability to work together. ●

Dr. Frank Grund

Chief Executive Director of Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

A common understanding of systemic risks in the insurance sector is a key priority

Subsequent to the financial crisis of 2007/08, the topic of systemic risk in the insurance sector has been discussed extensively over the last ten years. In 2018, the International Association of Insurance Supervisors (IAIS) sought feedback on its latest development in this area, the "holistic framework", as part of a public consultation. One component of this framework, which I very much welcome, is an activities-based approach to systemic risk in the insurance sector. In addition to this, the framework includes an entity-based assessment of individual insurers. Alongside the potential threat to global financial stability posed by individual insurers the activities-based assessment seeks to identify those activities that insurers engage in that could potentially threaten global financial stability under specific circumstances. Overall, >>>

>>> I support the IAIS's approach of looking at systemic risk through a combined lens that is able to zoom in on the activities of individual firms but also zoom out to keep track of developments in the sector as a whole.

One lens is to identify five exposures that might lead to a potential systemic impact via three defined transmissions channels. The exposure measures - fully supported by BaFin- are: liquidity risk, macroeconomic exposure, counterparty exposure, substitutability and other such as operational risk or wide-spread under-reserving. Another lens is the systemic impact that might be then possible through the transmission's channels of asset liquidation, exposure channels or either the fact that one deals with a critical function.

One final important element for me is the ongoing work of the IAIS on the concrete implications for policy measures of dealing with potential systemic risk arising from several insurers at the same time. Policy measures should be divided into preventive and corrective measures. In the first category, BaFin includes, amongst others, liquidity management plans, recovery plans and stress testing. Corrective policy measures, in contrast, include limits or regulatory stays.

A global monitoring framework should assess potential trends in the insurance sector as well as the potential risk arising from individual companies for the sector as a whole. In my view, it is therefore crucial that we construct a solid framework that monitors sector-wide developments so that, as supervisors, we are in a position to react to emerging risks before they reach a level that threatens financial stability. The same is true for individual firms: we as supervisors should be in a position to identify the next AIG before it reaches a critical stage and causes a meltdown in the financial markets.

I firmly believe that all of these developments will help the global supervisory community to create a toolkit specific to the insurance sector with which we can assess, identify and monitor potential systemic risks in an efficient and effective manner.

Arriving at a common understanding of systemic risks in the insurance sector that takes into account the fact that these risks are different to those of the banking sector is a key priority. It remains to be seen whether we will achieve this goal – which is why the IAIS is rightly planning an implementation assessment for 2022. ●

Eugenie Molyneux

Chief Risk Officer of Commercial Insurance, Zurich Insurance Group

Assessing challenges of a holistic framework for systemic risk in the insurance sector

In the past, macroprudential rules were intensively debated and primarily focused on the banking sector. Considering the insurance sector, they currently figure prominently on the agenda, both at global (IAIS) and EU-level (EIOPA).

The main goal being to mitigate potential systemic risk in the financial system, considerations must focus on identifying risks and vulnerabilities across all sectors.

"Insurers do not consider essential the development of additional macroprudential tools."

\- EUGENIE MOLYNEUX

For the insurance sector, a holistic approach to systemic risk should comprehend the complex web of dependencies and interactions between different actors, take into account international regulatory developments and determine the appropriate level of legislation.

We are pleased that EIOPA considers that EU-level work on systemic risk must be consistent with international developments and not pre-empt them. Indeed, while the International Association of Insurance Supervisors (IAIS) is currently developing a holistic approach to systemic risk in insurance, in parallel, EIOPA is committed to develop its own European framework.

Regulatory developments addressing systemic risks should appropriately consider the differences between the business models of banks, insurers and other financial institutions.

The core business of an insurance company, such as Zurich Insurance, is of long-term nature and its investment strategy is very risk averse. Given the limited level of systemic risk originating from the insurance industry, additional macroprudential measures are not necessary.

Before discussing additional measures, supervisors and regulators must focus on the implementation of the regulation currently in force, assess to which extent microprudential measures may already address macroprudential challenges.

In fact, at the EU-level, the insurance supervisory system already includes a fully functioning monitoring framework (i.e., specific reporting requirements for financial stability, EIOPA's biannual financial stability reports and stress tests) and many instruments with a macroprudential impact. For instance, Solvency II, currently under review, includes many macroprudential elements, the impact of which will only become apparent over time (long term guarantee measures - volatility adjustment, matching adjustment, the symmetric adjustment for equities; the ORSA mid-term view and scenario analysis).

The negative impact of over-regulation is clear, particularly on insurers' socially-essential roles of risk carriers and as long-term-oriented investors. New measures would be costly, not only for insurers but also for the society in general. Further, it would come on top of the very costly implementation of Solvency II.

An in-depth cost-benefit analysis is required before a macroprudential framework can be fully implemented. Those tools should be applied at group level, given the intention is to address risks to the entire financial system.

Macroprudential supervision for insurance, if at all needed, should be specific to insurance, and, those secondary risk drivers that could be channeled by insurance. If there are aspects of financial stability that go beyond the current regulation, these should be discussed in the context of the 2020 review of Solvency II. ●