Association of British Insurers

ABI RESPONSE: IAIS CONSULTATION ON NON-TRADITIONAL NON-INSURANCE ACTIVITIES AND PRODUCTS

25 January 2016

Prior to responding to the individual questions, we would like to take this opportunity to make some overarching comments on the proposed NTNI framework.

We appreciate that the IAIS has adopted an analytical approach to developing a framework for identifying NTNI activities; this is an important step.

In our responses to the consultation questions, we identify specific areas where we think further improvement to the methodology would be desirable. In addition to these, however, we would also urge the IAIS to consider the broader impact of the NTNI identification framework, and the incentives it offers.

It is important to consider the impact that the proposed methodology may have on consumers and savings, and the incentives it may create for design. For example, the current framework may incentivise insurers to incorporate high surrender penalties into policies. In cases such as this, it should be taken into account how the NTNI framework affects consumer outcomes, and whether this would be consistent with other regulatory and policy considerations. To elaborate, the impact of NTNI methodology on product design may be likely to have a negative impact on the consumers of savings products. Thus, proposals need to be tested against the objectives of conduct regulators and on the levels of savings: this may require the mapping out of the consequences with political decision-makers so that a holistic approach can be taken.

As well as product design distortions, insurers may be discouraged from offering what has been labelled as "NTNI" products and activities more generally. This relates to both how the NTNI concept is incorporated into IAIS capital workstreams, and how other regulatory bodies may re-interpret the concept. For example, there have already been suggestions by the European Systemic Risk Board of the possibility to ring-fence and limit or restrict NTNI products. The types of products caught by the current proposals can play an important economic role, and provide policyholders with the safety of protection against future events, be it an unfortunate accident or retirement. Any unintended consequences for the provision of these products therefore need to be carefully evaluated in advance.

For these reasons, it is important that – first of all – the methodology only captures products and activities that present true systemic risk, and – secondly – that the purpose and design of the methodology is clearly articulated. In relation to the second point, we agree that labelling what may be well-established insurance products as "non-traditional" is misleading and prone to misinterpretation.

In relation to the first point, that the methodology only captures products that are the source of systemic risk, we appreciate that the analysis is broken down by vulnerabilities and transmission channels. It is important to note that systemic risk arises on account of transmission to the system. The existence of vulnerabilities in itself does not create systemic risk – these are addressed by robust

micro-prudential regulation. The paper appears to be particularly focused on asset-side exposures, and we note that these risks, alongside those on the liability side, are already subject to micro-prudential regulation. Insurers' risk management processes are also relevant here. Therefore, the identification of vulnerabilities is an appropriate first step, as identified in the framework, but this is not in itself indicative of the presence of systemic risk.

The focus of systemic analysis should be on whether, and how, these risks could be transmitted to the rest of the financial system, and the impact on the financial system and the real economy this would create. In this context, it should be considered in what circumstances systemic risk is transmitted through these channels. It is also necessary to factor in actions – by both management and supervisors - that can be taken to mitigate the likelihood that risks are transmitted.

There are likely to be very few activities or products offered by insurers that are true originators of systemic risk within the financial system. In this light, it needs to be assessed whether the very comprehensive proposed methodology is commensurate with the outcomes of such analysis. If there are very significant, unmitigated, high risk exposures, then these should already be appropriately addressed through direct supervisory action.

Finally, it is important that the assessment of systemic risk be consistent across different participants in the financial system, while recognising the unique characteristics of each type of participant. We believe further work will be required to achieve this.

Question 1: **Based on the above characterisation of NTNI, is the terminology "non -traditional" confusing? If so, what might be a better term than NTNI? Additionally, what might be a better term than "traditional" for products and activities that are not NTNI?**

Question 2: Are there any other benefit or liquidity features that should be taken into account in identifying NTNI products and activities?

Before setting out suggestions for other benefit and liquidity features that should be taken into account, we would like to note that the framework does not appear to consider hybrid products (products that exhibit various combinations of the features). As these are very common in the insurance industry, further thought is required as to how the framework could accommodate this.

- The following benefit features should be included:
    - Index-linked benefits: e.g., could be tied to long-term inflation rate;
    - Insurance linked guarantees: guaranteed annuity options, renewal guarantees, longevity guarantees;
    - The consideration of guarantees should separate surrender guarantees that may apply at any time at the policyholder's discretion, from those that only apply at maturity or at single or limited dates, given their differing risk profiles.
- For liquidity features, the list should also include:
    - Ability and extent to which the firm can adjust surrender payments to match underlying asset values (even where these asset values are distressed). This is different to an 'economic penalty' and an important risk management feature.
    - Economic cost disincentive as discussed in our answer to Question 7.

We also note that footnote 9 of the consultation mentions that that a firm's derivatives hedging strategy may break down if they are unable to roll over hedges. While this is a possibility, such an event is a micro-prudential risk issue for the insurer. It is not clear how this creates systemic risk.

The other example used is of substituting market risk with counterparty risk. This, too is a micro-prudential risk and is managed via collateralisation and existence of counterparty limits. It is unclear how this creates risk for the system. The third example used is that demand for derivatives during a market downturn can cause derivatives prices to rise. Insurers offer long-term guarantees and do not necessarily have to be forced buyers of derivatives in stressed scenarios. The appropriate way to manage this risk is to ensure that micro-prudential regulation does not create pro-cyclicality. The tools that are proposed to be used for systemic risk management (i.e. enhanced supervision, recovery and resolution and HLA) will not lead to a reduction in this risk.

Question 3: **Do the identified transmission channels appropriately capture the ways in which the vulnerabilities could amplify shocks and create systemic risk? What, if any, other channels should be considered?**

We agree that it is appropriate to break down the analysis into vulnerabilities and transmission channels. It is important to note that systemic risk arises on account of transmission to the system. The existence of vulnerabilities is a pre-requisite, but it does not in itself create systemic risk – and is addressed by microprudential regulation.

We note that a similar conclusion was reached by the BCBS in its July 2013 report on the updated assessment methodology for banks: "*The Committee is of the view that global systemic importance should be measured in terms of the impact that a bank's failure can have on the global financial system and wider economy, rather than the risk that a failure could occur. This can be thought of as a global, system-wide, loss-given-default (LGD) concept rather than a probability of default (PD) concept*".

However, in the consultation paper, we believe that the distinction between vulnerabilities and transmission channels is often blurred.

In particular, when discussing the exposure channel, it is stated that an NTNI activity could allow a shock to spread more easily to other financial institutions or markets. It needs to be made explicit that this refers to cases where NTNI activities create more linkages with other financial institutions and have the potential to transmit risk, and, therefore, could have a more material impact if a failure was to occur. Exposure to risk as a result of an activity or product will not in itself lead to damage to the financial system or to the wider economy. There has to be a transmission channel.

In considering these linkages to other financial institutions, a distinction should be drawn between linkages that create exposure for the insurer and linkages where exposure is created for the counterparty. As the focus is on the transmission of risks to the system, it is the latter that is relevant.

This analysis of systemic risk needs to be distinguished from the consideration of the likelihood of failure of an individual insurer, or that where the impact of a linkage is on the insurer itself (e.g., if an insurer buys an option): both are micro-prudential regulation issues and should not be confused with systemic risk. We agree that certain types of activities are riskier, and therefore more likely to

lead to the failure, but these should already be addressed by robust regulatory regimes, including enhanced supervisory scrutiny where appropriate.

To summarise, as part of the assessment, you would therefore need to look at whether:

1) a product or an activity involves a linkage which creates increased exposure to the rest of the financial system;
2) this is the type of linkage that increases exposure for the *other* financial institution;
3) the exposure is likely to be a transmitter of risk, and allow shocks to spread more easily. This should include analysis of insurer's risk management practices to determine whether there could be any material residual risk that cannot be contained within the insurer. This should include consideration of Systemic Risk Management Plans (SRMPs) and Recovery Plans (where available), as these provide a sophisticated way to assess the degree of residual risk. The likely management and supervisory actions to reduce the risk of transmission also need to be taken into account;
4) the probability - and circumstances - of scenario(s) where this risk transmission mechanism could be triggered;
5) if the product or activity meets the four conditions above, there needs to be an evaluation of the likely materiality and consequences of this transmission, on both the financial system and the real economy (i.e., is there capacity to have a significant negative impact on the financial system and the real economy).

Question 4: **Are these the appropriate two steps that should be used to assess whether a benefit feature could exposure the insurer to substantial market risk? What other steps, if any, should be considered in the analysis? Should the two steps be given equal weighting in the assessment of whether a product has substantial market risk? Should the nature of the two step analysis be disjunctive or conjunctive?**

In assessing product features that create market risk, the IAIS has only included the ability to match liability cash flows ignoring the use of derivatives. However, derivatives are a key risk management tool for insurers. Derivatives are typically used to reduce exposure to risks (e.g., inflation or interest rates), or as part of insurers' asset-management strategies (i.e., by buying a swap to manage asset duration to match liabilities).

It is likely that derivatives are bought at inception of contracts and held to maturity, and ongoing trading is therefore not necessary. Furthermore, we note that the various types of derivatives may have different systemic implications. For example, if an insurer buys options, the insurer is exposed to counterparty risk, but does not create counterparty risk for the seller (going back to the discussion in question 3 on linkages that create exposure for the *other* party).

If the reason for dismissing the use of derivatives is that they are perceived as 'risky', we note that insurers are prohibited from speculative derivative trading. In relation to the IAIS's concerns regarding counterparty risk and access/cost in times of stress, these considerations are not unique to this asset class (e.g., there are concerns being raised about the liquidity of bond markets under stress as well) – and these concerns should not be exaggerated.

If the concern is that derivatives transfer risk from one part of the system to another, we would like to note that buying derivatives need not only imply transfer of risk from insurers to other players. This could also imply pooling of risks and risks residing in part of the system where they are best managed. Finally, there has been extensive global and national efforts to make derivatives safer and, in particular, to significantly mitigate the counterparty risk through the introduction of central

clearing and collaterisation. For these reasons, we strongly feel that it is disproportionate to disregard the role of derivatives.

Paragraph 3.3: it is not clear what is meant by "undiversifiable" market risk – and particularly in which types of cases this might be "significant". Market risk can be diversified by taking on a broad spread of risks. Where a particular insurer is exposed to concentrated market risk, this can be addressed as part of microprudential supervision. It is not clear in which instances this cannot be diversified or addressed through other risk management tools.

Figure 2: the flow chart should also consider the possibility of mitigating risks through management and supervisory action, as well as the wider context of insurers' risk management.
Question 5: Does the list above assess a comprehensive set of benefit features? What, if any, benefit features are not assessed in this section that the IAIS should consider? Do the benefit features listed in this section help provide the IAIS with sufficient information to characterise products and activities as NTNI in a way that applies equally across jurisdictions?

For the fixed benefit and profit participation benefit types, the assessment of exposure to market risk should reflect whether the insurer has the ability to adjust the surrender value to match market movements, including any guarantees of surrender values.

Question 6: Do the proposed time periods appropriately capture liquidity risk?

We would agree with the statement made in 3.11 that it is "more likely that a complex interaction between contract features, the state of the insurer, the market environment, individual characteristics and other dynamics will determine the extent to which counterparties have an incentive to surrender". Therefore, focusing on only two factors is not a good proxy to determine the risk of a run. It would be more appropriate to consider the insurer's ability to manage liquidity risk. This needs to be considered in the context of existing liquidity risk management planning requirements, including the LRMP for G-SIIs.

Paragraph 3.9: it is not clear why the IAIS has singled out insurance contracts of short-term duration. If the issue relates to matching, as the first part of the paragraph suggests, the question should be whether short-term assets can be found to match these liabilities appropriately.

Section 3.2.1.1 (delay in access): as mentioned elsewhere in this response, the ability of both insurers and supervisors to place a stay on access should be taken into account.

Question 7: Other than contractual penalties or taxing requirements, what other economic penalties should be captured? These should be readily quantifiable and generally applicable (i.e. not policy- or policyholder- dependent).

The combination of a) contractual terms allowing for very short settlement periods, b) surrender value guarantees, and c) a high proportion of institutional investors as policyholders, has proved in the past to cause issues to insurance companies facing mass lapse events. The IAIS should make this the main area of focus.

Regulatory action: It should be noted that the FSB's annex to its *Key Attributes for effective resolution regimes* notes that resolution authorities should have at their disposal a broad range of powers, including a power to suspend insurance policyholders surrender rights. Therefore, the power to stop surrenders should be taken into account in any consideration of disincentives to surrenders.

Policyholder Protection Schemes should also be considered, as where policyholders are protected under such schemes they will have greater security and less incentive to surrender.

There are many factors that may provide **disincentives to policyholders to surrender policies**. For example, policyholders would need to weigh up whether, if they were to surrender, they might:

- crystallise investment losses that may otherwise be recovered over time;
- lose valuable benefits/guarantees only payable at specified contractual events, such as final bonus payments payable on contractual maturity;
- crystallise tax implications that they have not planned for;
- lose benefits provided under their policy that cannot be replaced;
- not be able to secure alternative cover on the same terms with the same product features;
- incur additional costs in securing alternative provision that would impact their investment;
- require advice which may be costly.

Therefore, given the range of factors, it is not clear why the IAIS is only focusing on exit penalties. This is just one of many interacting factors and does not represent an accurate overall proxy.

The **assessment of economic penalties** should explicitly recognise that for some products the policyholder cannot access the funds until a specified date, but may be able to transfer the funds between product providers and, in such cases, there will be an economic cost that does not arise from penalties on surrender. For example, pension accumulation products within the UK, given their tax status, do not allow policyholders to draw benefits until retirement age. Policyholders may transfer their funds between product providers, but in doing so would incur changes from the new provider. This is an economic cost in addition to any penalty that may be imposed.

We do not consider that **pension fund transfers**, where permissible, are a liquidity feature close in nature to deposits, as the policyholder is not able to withdraw the funds, and determining whether a transfer would be beneficial is not a simple matter.

The extent to which surrender values can be **adjusted to match market values** is also a critical consideration.

Therefore, in addition to the three economic penalties listed, we would recommend that a fourth – '**economic cost disincentive' -** is added. This should also be set as 'High' to reflect the economic and opportunity costs to policyholders.

Question 8: Do the proposed economic penalty thresholds appropriately capture the monetary disincentives to surrender?

As mentioned in our general comments, we would urge the IAIS to consider the broader set of incentives that the NTNI methodology would provide. For example, this section of the methodology could encourage policy design to incorporate very high withdrawal penalties. This needs to be weighed up against the objectives of conduct regulation, and public policy objectives more broadly.

Turning to the thresholds proposed, we do not consider that 20% is representative of penalties applied within the industry, and believe that 5% would be a more appropriate threshold. It is not clear how the IAIS has arrived at these numbers. Setting the threshold at this level may incentivise insurers to increase surrender penalties. This would be inconsistent with the fair treatment of policyholders and introduce an unreasonable barrier to exit.

In addition, as noted in our answer to Question 7 above, there are many factors that may provide disincentives to policyholders to surrender policies. Therefore, focusing only on surrender penalties does not provide an adequate assessment of the full economic cost.

Question 9: Are the above factors relevant to insurers' exposure to liquidity risk? How might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms?

Before addressing the specific question, we have the following comments on the overall approach to assessing liquidity risk and whether this creates systemic risk.

It needs to be clarified whether the systemic risk concern relates to the impact of asset liquidation (if any) on the asset markets, or to losses incurred by insurers where surrender values paid out are more than the value of the assets backing liabilities.

The latter issue is a micro-prudential regulation issue and does not create systemic risk in itself.

In considering the former issue, a broader systemic view needs to be considered:

- In cases where policyholders have choice of asset allocation, the issue is not insurance sector specific. The same choices would be made if the investments were made via other intermediaries or directly. In the case of insurers, the presence of cover/guarantees would only reduce incentives to withdraw. Therefore, penalising insurers will not reduce systemic risk on this count.
- In cases where insurers decide the asset allocation, there is more flexibility to not liquidate the illiquid assets. In such cases, insurers could potentially sell more liquid assets to fund any increased surrenders.
- In any case, if there are increased surrenders, the monies will move from one part of the financial system to another part and it is important that the systemic risk is not exaggerated. We also note that reference to bank deposits runs are made a number of times to explain the liquidity risk – it should however be noted that the banking methodology does not consider the size of retail deposits as an indicator in determining systemic riskiness.

There are additional factors that should be included, which we comment on in Question 10.

In response to the specific question regarding the use of ancillary factors, we welcome the consideration as these are very relevant in assessing the risk of liquidity in insurance products. However, we believe that loss of guarantee is not given adequate importance in the analysis as it is included in the "wider set of factors", rather than the list of "narrow set of factors". We believe that guarantees are valuable to policyholders and will be even more valuable when markets are down. This will therefore be expected to be a strong disincentive for policyholders form surrendering.

The quantitative data collection should be expanded to reflect the wider factors that are relevant to determine exposures to liquidity risk.

We suggest that the identification of NTNI products and the level of systemic risk of NTNI products in each jurisdiction relies on the expertise of national supervisors based on the framework set out by the IAIS. It is also imperative that mechanisms are put in place to ensure consistency of application globally.

Question 10: What other considerations might be relevant to insurers' exposure to liquidity risk? Should these be incorporated into the framework as ancillary factors? To this end, how might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms?

In considering liquidity risk, we welcome that IAIS has included the consideration of ancillary (qualitative) factors in addition to the contractual time delay in access to funds and penalties levied on surrender to assess the liquidity risk.

We would like to suggest the following additional considerations:

- An additional factor to be reflected as part of loss of guarantees is the **loss of final bonus payable on maturity** as this will provide a disincentive to surrender.
- In many cases, the insurer will have a **contractual ability to delay surrenders.** If resolution authorities also have the power to apply temporary stays, this would also help to mitigate risks, and should considered in the analysis.
- Another relevant consideration is the **flexibility to adjust fund values** so that policyholder surrender/maturity values reflect their fair share of the asset pool and do not disadvantage other policy holders, e.g., MVA for UK With-Profits funds.
- The **operational differences** between banks and insurers should also be recognised. While bank depositors can access funds immediately through ATMs, bank branches or online banking, insurance policies cannot be surrendered in the same way.
- The **upfront cost of advice** to the customer for advice on replacement insurance/pension accumulation fund transfers.
- The **loss of qualifying status for tax benefits** should also be explicitly reflected in addition to tax penalties.
- **Pension accumulation product fund transfers** – as noted in our answer to Question 7.
- Impact of **charges to policyholders funds** when taking a replacement product as referred to in Question 7.
- In focusing on liquidity risks it is necessary to **consider the underlying asset pool**, and not just the policy benefits. This should take account of the level of liquidity held, the liquidity of other assets in the pool, the ability to call on other asset pools, and expected (stressed) cash flow from new business. It is therefore important to focus on liquidity management.

The quantitative data collection exercise should reflect these factors which the group supervisor should assess alongside the insurer's SRMP (where insurers are required to prepare one). These should be discussed with the insurer to ensure a consistent understanding.

The IAIS should adopt effective mechanisms, including a peer review process to achieve consistency in the application of assessments globally.

Question 11: For those products with both protection and savings components, how should the distinction most clearly be drawn between those that resemble deposits and those that do not? Which considerations should be included in the narrow and the wide sets of ancillary factors?

We would suggest that assessment for each jurisdiction be made whether products have significant insurance cover or not. This could be based on comparison of the death (or health benefit) relative to surrender values. E.g., if death benefit / surrender value >x, there is a sufficient protection component.

We believe guarantees are as important as protection and should be a narrow factor. Consideration should also be given to the combination of how product features are packaged with the ability and capabilities to support good risk management. The robustness of risk management strategies in stressed conditions is vital.

Question 12: How should the IAIS think about the liquidity risk of products that combine savings and protection benefits? Does the proposed approach appropriately reflect the potential liquidity risk on such products or would there be a better way to address this?

For savings products which have protection benefits, it should be considered that this protection is a valuable long-term component for the customer. It therefore reduces the potential liquidity risk, as there is a benefit of holding onto the product. I.e., adding protection benefits to savings products can be a liquidity risk benefit to firms. Further, if there is no insurance protection but investment guarantees, the guarantees should be seen as a disincentive to surrender.

Question 13: Recognising that they are not determinative, what other factors might influence insurers' exposure to market or liquidity risk?

Question 14: Should these factors be taken into account as determinative in the NTNI classification? To this end, how might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms? To what extent, if any, do these factors allow for the consistent application of the NTNI concept across jurisdictions?

The use of derivatives should not be considered determinative – while this may be an indication of NTNI activity, this cannot be objectively assessed across jurisdictions and firms which have differing hedging capabilities. Please also refer to our responses to questions 2 and 4 for a discussion of insurers' use of derivatives.

Question 15: Is the list of products and activities set out in Annex 1 representative of the insurance activities and products that are conducted in the listed jurisdictions? Are there other products and activities that should be added to the list, for example because they have similar features as those in Annex 1? To what extent, if any, will the analysis of the products and activities in Annex 1 allow for the consistent application of the NTNI concept across jurisdictions? Also, are there additional or alternative terms for the listed products and activities that should be added to improve the completeness and clarity of the list?

Universal life is missing from the list, and perhaps some consideration should be given to product packaging, secondary benefits and riders.

"Certain types of property and casualty/liability insurance" is a rather wide category, and it is not clear what the IAIS thinking on this is.

Paragraph 5.2: In the conclusion, it is stated that "*Product features that have a guaranteed benefit and for which the insurer does not have the ability to invest in assets that will yield sufficient cash flows to pay off expected claims (ignoring derivatives), could expose the insurer to substantial market risk and therefore be classified as NTNI.*" We reiterate that assuming market risk in itself does not create systemic risk. It is important to consider transmission mechanisms and when considering transmission mechanisms, it is important to consider whether insurers expose counterparties to risk

or are exposed to risk from counterparties. Such conclusions, without drawing the attention to transmission mechanisms, can exaggerate the perception of systemic risk created by insurers.

Question 16: In light of your response to this Consultation, to what extent, if any, should the IAIS revise the existing NTNI Principles to allow for the consistent application of the NTNI concept across jurisdictions? To what extent do the three Principles help inform the IAIS' common understanding of what products and activities should be classified as NTNI? Please explain your answer.

Consistency among supervisors can be the focus of IAIS peer review. NTNI principles should focus more on transmission channels and less of vulnerabilities.

It is important that the assessment of systemic risk be consistent across different participants in the financial system, while recognising the unique characteristics of each type of participant. We believe further work is required to achieve this.