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January 25, 2016

Mr. Yoshihiro Kawai
Secretary General
International Association of Insurance Supervisors
c/o Bank for International Settlements
CH-4002 Basel
Switzerland

RE: *Non-traditional Non-insurance Activities and Products* Public Consultation Document (Nov. 25, 2015)

Dear Secretary General Kawai,

On behalf of the American Academy of Actuaries'[1] Solvency Committee, I appreciate the opportunity to provide comments on the International Association of Insurance Supervisors' (IAIS) *Non-traditional Non-insurance Activities and Products* public consultation document, dated Nov. 25, 2015 (the Consultation).

Before addressing the questions in the Consultation, we would like to offer the following general comment:

The Consultation has identified useful principles to assist regulators in the evaluation of market and liquidity risks arising from insurance products. We have concerns, however, that these principles may result in prescriptive presumptions of systemic relevance based on specific product labels and features. Insurance markets differ markedly from one another internationally. Product lines, regulatory and tax regimes, consumer behavior, and many other factors can be very different from country to country. Local regulators should be afforded discretion to apply these principles flexibly, making adjustments when needed in order to accommodate their respective markets and regulated insurers.

Below are the committee's specific responses to questions 1-2, 4-10, and 12-16, organized by section and question number.

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[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

1850 M Street NW Suite 300 Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

Section 2 – Elements of the Analysis

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?

Response: Yes, the term "non-traditional" could create confusion.

The introduction to the Consultation explains that one main objective is to "provide further clarification on the concepts of NT and explain how their characteristics drive their ***systemic relevance***." (emphasis added) As this statement suggests, the concept of "non-traditional" is focused on identifying potential sources of systemic significance or risk, and is not intended to define whether an activity is one that insurers have "traditionally" pursued according to the ordinary meaning of that term. As the Consultation notes, an activity might generate systemic risk, even though it is one that has a long-established history, and is therefore one that is "traditionally" offered by insurers in a particular marketplace. Similarly, new products or practices may not be systemically risky, or might reduce overall systemic risk, despite being new or innovative.

The term "traditional" also conflicts with the important goal of ensuring that standards are applied transparently and as consistently as possible across diverse jurisdictions. An activity that is new and therefore "non-traditional" in one jurisdiction may be well-established and therefore "traditional" in another jurisdiction. Applying the term "non-traditional" in such a context could create confusion in those jurisdictions in which the IAIS determines that a well-established product or practice, with a long history and "tradition," is actually "non-traditional." What is really meant is that the product or practice potentially generates elevated systemic risk, irrespective of its history in any particular market.

As alternatives, we suggest terms that explicitly refer to systemic relevance. Alternatives could include terms such as "systemic risk connected," "systemic risk contributing," "systemically significant," or "systemically relevant" products or activities. Terms for other products or activities could include the express opposites of these labels (e.g., "non-systemic risk connected" or "systemically neutral" products or activities).

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

Response: General comments on the list of benefit and liquidity features appear immediately below, followed by specific comments on several of the features included in the list.

General Comments

The Consultation explains, in Section 2.4, that it is focused "on insurance product features," and notes that activities envisioned under NTNI Principle 3, including investment or capital markets activities that create "maturity or liquidity transformation or imperfect transfer of credit risk," are not considered in the document but "would still constitute NTNI." We question whether it is desirable to focus a substantial portion of the NTNI framework on specific product features.

Any attempt to classify product features risks oversimplifying the complex, difficult question of whether a particular insurance company practice, in a specific jurisdiction, generates systemic risk. Product features and the systemic impact of any given practice can vary significantly by jurisdiction. Demographic profiles and cultures, as well as consumer behavior, differ materially in various parts of the world. Contract terms for similarly titled products also can vary widely from country to country.

The proposed approach also focuses on features without taking into account how their relative size in a company or a market affects systemic relevance. It is not the absolute size of an exposure that contributes to systemic risk, but rather the relative size when compared to an entity's capacity for that risk. A small firm may have a large concentration of systemic risk-contributing products that theoretically might affect other parts of the financial system. A large firm may write more of those products, but well within its capacity for the liquidity demands, such that the exposure in that firm does not lead to system-wide risks. It may be that relative size will play an important role when the NTNI concept is used in other regulatory contexts, but if that is the case, the NTNI criteria should be clear that relative size will be a significant factor in any context in which NTNI is being implemented in a specific regulatory action.

A feature-based approach also discounts the importance of risk mitigation techniques that are common in the insurance industry, and does not account for the contribution of different risk management approaches among companies to the generation and propagation of systemic risk in the economy. While a large forced asset sale by one or more insurers might impact other parts of the financial sector, an inability to appropriately manage liquidity may be the reason for the forced sale, rather than specific product features. For example, the use of securities lending in an investment portfolio for life insurance products will not invariably generate systemic risk. Investing collateral in short-term assets prevents maturity transformation from taking place. Systemic risk is created only when the collateral is invested in illiquid assets, and the insurer does not maintain enough other liquidity to cover its short-term securities lending obligations. It is not the product features that are responsible for the systemic risks. Instead, it is the potential mismanagement of an investment strategy that could support any number of different products that generates the systemic risk. This important nuance will not be captured if the approach focuses too heavily on product features, without giving sufficient attention to risk management practices and other activities that accompany those features.

For these reasons, generating a label for specific product features and attempting uniform application of that label across jurisdictions is unlikely to appropriately identify systemic risk. Instead, it is important that the IAIS allow flexibility to local regulators to evaluate systemic relevance based on the regulator's specific market, and in light of the specific features of each company that is being regulated. A regulator should be given the tools to apply general principles in as consistent a manner as is practical, but should not be bound by a presumption that a specific product feature will generate NTNI in his or her jurisdiction or for any particular company.

Specific Comments

- *The Effect of Insurance Protection on Liquidity*. The list of benefit and liquidity features does not take into account the effect that insurance coverage can have on the likelihood that consumers will treat their insurance products as a source of liquidity. For example, in the United States, consumers are often reluctant to surrender a life insurance product that provides significant mortality protection, even when the product also builds cash value during the insured's life. There is a rational basis for this reluctance. Upon surrender, the insured loses mortality protection and may not be able to obtain it again on similar terms because of underwriting requirements, particularly when a long-term product is involved. The prospect of paying deferred income tax on accumulated cash value magnifies the disincentive to surrender. The natural reluctance to surrender makes the product significantly less liquid. While the Consultation recognizes that this disincentive to surrender might be an "ancillary factor" that is capable of rebutting a presumption of liquidity risk, we are concerned that this treatment does not give sufficient emphasis to the decisive role that such disincentive can play.

- *Cash-Flow Matching*. The list also includes a "benefit feature" category to measure the insurer's ability to invest in a way that matches the expected cash flows of a product's liabilities. This category only includes features that are based on "contractual limitations" that affect an insurer's investment decisions. However, in some cases, an insurer may have unlimited contractual freedom to invest in assets of its choosing, but cash-flow matched assets may not be available. For example, assets of sufficient duration may simply be unavailable to match a liability that has a very long expected term.

It is also unclear how descriptions of features in this cash-flow matching category are intended to apply to property and casualty products. For these products, the amount and timing of the insurer's payment obligations can be uncertain. Generally, there will not be assets available with payment amount and timing characteristics that match this uncertainty in the nature of the liability. Although this disconnect is not necessarily one that creates any systemic risk, the criteria in the list could be interpreted to imply such a risk. To eliminate this problem, we suggest specifying that the cash-flow matching category is not intended to apply to property and casualty products.

Section 3 – Analysis of the Vulnerabilities

Question 4. Are these the appropriate two steps that should be used to assess whether a benefit feature could expose 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?

Response: While the two steps proposed provide a useful framework for the evaluation of market risk, we are concerned that the IAIS is not allowing enough room for supervisory judgment. Given the vast range of products, the wide array of individual company profiles, and the numerous and diverse jurisdictions involved, it is important to avoid an overly prescriptive approach. Presumptions of substantial market risk, or an exhaustive list of sources and exceptions to this risk, will be untenable. Consider, for example, products like life insurance and annuities that naturally hedge each other. Each may serve as a source of some market risk, but in a company that has such a natural hedge, a substantial part of the market risk is eliminated. The proposed framework would not take this into account, but it is a potential mitigating factor that a regulator should be empowered to consider when applying the framework.

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?

Response: Making blanket categorizations across all jurisdictions and companies for a given product label is not recommended. Products perform differently within different jurisdictions. Moreover, even if a product can create liquidity risk across multiple jurisdictions, that risk may be easily mitigated through asset management strategies, suggesting that the categorization of the product should be dependent on the availability and deployment of these strategies, and the availability of the assets necessary to deploy them (e.g., whether sufficient long-duration assets are available in a given market).

We note that the list does not adequately address insurance products that provide performance guarantees in which an insurer agrees to complete the performance if the original party does not perform. In some cases, this performance would then take place over months or years, such as for a construction surety bond. For some other products, the performance would require an immediate cash payment upon lack of performance by the original party. The former does not generate liquidity risk, while the latter may generate such risk if sufficient asset liquidity is not maintained. Therefore, we suggest adding a description of performance bonds, with clarification as to the two types of performance that may be required.

While we agree with the conclusion that liabilities for "profit participating" products "are generally not correlated with the market" and can usually be cash-flow matched, we note that the description of the product does not match many of the types of products that are labeled as "participating" in the United States, Canada, and some other countries. For example, the list states that participating products "contain a guaranteed rate of return" that exposes the insurer to market risk. Dividend-paying whole life insurance products in the United States allow a return of premium through payment of a periodic dividend, but the dividend payment is typically not guaranteed. A minimum cash value is guaranteed, but that amount does not typically include participation in the dividend.

Furthermore, the last row of the table states that Mortgage Insurance (MI) products expose insurers to a high degree of market risk. While we agree that default events for MI are highly correlated with market cycles, MI providers can reasonably cash-flow match their assets to their liabilities. MI providers periodically model liability cash flows resulting from stress events. These modeled liability results can then be used by asset managers to ensure sufficient cash flows are available to meet liability cash flows even during adverse market cycles. In addition, MI providers have leading risk indicators for when default events are increasing in likelihood, which allows the organization to prepare for and manage the increasing market risk. We would therefore suggest the IAIS revise the characterization of MI as highly unpredictable and unable to be cash-flow matched.

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

Response: It is unclear whether this “delay in access” concept is intended to apply to the claim liabilities that result from property and casualty contracts. In some cases involving these contracts, the final payment amount is based on investigation and some degree of negotiation or settlement discussion, if not litigation, as to the amount of damages or whether damage payments are due at all. This process creates a natural lag in the cash outflows that generally is longer for the larger (and typically more complex) claims, and does provide some degree of control over cash outflows for the property and casualty insurer.

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).

Response: While it is appropriate to take contractual penalties and tax impacts into account, it is important to ensure that the incentives created by these types of penalties are not overemphasized in the framework when compared to other economic incentives extrinsic to the contract or its taxation. These other kinds of economic incentives can be just as important, or potentially more significant, in the overall analysis, depending on the product and jurisdiction. For example, as we discussed in our answer to Question 2, the loss of mortality coverage, and its potential unavailability in the future for underwriting reasons, can create powerful economic disincentives for a consumer considering surrender of a life insurance policy.

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

Response: It is difficult to assess the economic penalty thresholds, because it is unclear what is meant by a penalty that is “less than 20%” or “more than 20%.” To what number will the percentage be applied, and how would this measure be adjusted from product to product, or to account for jurisdictional differences in products or markets? In addition, it is unclear whether these economic penalties are intended to take all tax impacts into account. Like other relevant factors, tax regimes also differ widely from jurisdiction to jurisdiction.

We recommend an approach that is principle-based rather than prescriptive and that allows discretion to individual regulators to make calibration and other relevant decisions during implementation in order to take jurisdictional and company differences into account. While the presence and amount of any economic penalties are certainly relevant to the analysis, they should not be used to create a presumption of systemic relevance.

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?

Response: Yes, these additional factors can play a significant, and sometimes decisive, role in determining how much liquidity risk an insurer faces. As with the other factors discussed in the Consultation, their precise nature and impact can vary significant across jurisdictions. Government protection plans, for example, can play a decisive role in preventing runs on financial institutions, but they differ in material ways from country to country. Depending on the jurisdiction, a regulator’s ability to delay benefit payments also could be important in situations when markets are in short-term turmoil. The factors outlined should not be used to create rigid presumptions for uniform application internationally, but instead should inform broad principles that regulators can use when implementing the parts of their particular regulatory regimes that relate to the NTNI concept.

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?

<u>Response</u>: The nature of a product's target customer could, in some cases, be a relevant consideration in the NTNI determination. Retail consumers and sophisticated institutional buyers tend to behave differently, have different appetites for transparency and complexity, and have different incentives that may be relevant when evaluating the potential impact of a product or activity in a time of market stress. In some cases, though not all, simpler retail products may be less likely to be systemically relevant. While this factor may not be determinative, it could be a relevant consideration for regulators.

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?

<u>Response</u>: We are concerned that the proposed approach does not adequately take into account the strong mitigating role that protection benefits play in the reduction of market and liquidity risk that a product's savings component might otherwise generate. The prospect of losing protection can substantially reduce consumer incentives to access the savings component of an insurance product, particularly when an array of other products are available from banks and similar institutions to serve the market's need for pure liquidity and savings products. Tax liabilities triggered by surrender also can create a meaningful check on liquidity. To address this concern, regulators should be able to take the mitigating role of protection benefits and tax impacts into account when applying the NTNI framework in a particular jurisdiction.

<u>Section 4 – Other Relevant but Non-determinative Factors</u>

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

<u>Response</u>: There are other risk mitigation and management strategies that can reduce potential systemic risk substantially and therefore should be considered. Specifically, government reinsurance mechanisms and collateral requirements that are designed to mitigate or eliminate market or liquidity risk should be taken into account. In addition, some products may be quasi-governmental in nature, such that the insurer acts only as a servicer for a government social program, with the government absorbing any market or liquidity risk. The governmental support should be considered as a relevant factor.

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?

Response: If a product can be made non-systemic via an appropriate risk mitigation strategy or other factor, then the existence and deployment of such a strategy or other factor should be taken into account, and should be considered to be determinative, as doing so creates an incentive to reduce systemic risk. If, instead, these strategies and other factors are not taken into account, or if they are not treated as determinative despite a decisive impact, there may be a disincentive to reduce systemic risk. For example, a risk mitigation strategy may have a cost, and those who do not employ the strategy would not have to bear that cost, potentially giving them a competitive advantage over those insurers that follow the strategy.

A flexible, principle-based approach is best suited to the challenge of assessment, weighting, and consistent application. Because of differences among jurisdictions, local regulators will require a significant level of discretion. The public would not be well served by a rigid, prescriptive approach that does not sufficiently account for prudent risk management strategies or meaningful differences among product lines or jurisdictions. Such an approach could create unneeded costs for the marketplace and may not provide jurisdictions with sufficient incentive to regulate systemic risks out of their marketplaces.

Section 5 – Conclusion

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?

Response: The references to "certain types" of "property and casualty/liability" and "health" insurance are vague and quite broad. Many disparate, individual product types are subsumed within these categories. As such, it is unclear what specifically will be evaluated in these areas.

We also note, as in Question 5, that in many cases, dividend-paying participating life insurance products in the United States will include minimum guaranteed cash values, but typically will not include a guaranteed dividend payment.

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.

Response: While we believe that the IAIS has identified a useful group of principles that are relevant to the evaluation of market and liquidity risks associated with insurance products, we are concerned that these principles may be used to develop overly prescriptive presumptions, linked to specific product labels and features, for implementation across disparate jurisdictions. Insurance markets around the world differ considerably from each other. There is wide variation among product lines, tax regimes, consumer behavior, policyholder protection schemes, and many other relevant factors. As such, local regulators should be afforded discretion to apply the Consultation's principles flexibly, making exceptions and other adjustments as relevant for their individual jurisdictions.

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Thank you for the opportunity to provide feedback to the IAIS on its NTNI Consultation document. If you have any questions or would like to discuss these issues in more detail, please contact Nikhail Nigam, the Academy's policy analyst for risk management and financial reporting, at +1-202-785-7851 or nigam@actuary.org.

Sincerely,

Elizabeth K. Brill, MAAA, FSA
Chairperson, Solvency Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

cc: Michael McRaith, Director, Federal Insurance Office, U.S. Department of Treasury
Tom Sullivan, Senior Adviser for Insurance, Federal Reserve Board
Commissioner Kevin McCarty, Chair, ComFrame Development and Analysis Working Group, National Association of Insurance Commissioners
David Sandberg, Chair, Insurance Regulation Committee, International Actuarial Association
William Hines, Chairperson, Financial Regulatory Task Force, Risk Management and Financial Reporting Council, American Academy of Actuaries