INSTITUTE OF
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Dr. Victoria Saporta
Chairperson
Mr. Jonathan Dixon
Secretary General
International Association of Insurance Supervisors (IAIS)
Centralbahnplatz 2
CH-4051 Basel
Switzerland

Re: Draft Application Paper on Macroprudential Supervision

Dear Dr. Saporta and Mr. Dixon:

The Institute of International Finance (IIF) and its insurance members welcome the opportunity to comment on the IAIS's Draft Application Paper on Macroprudential Supervision (Draft AP). We appreciate the need for and importance of further supervisory guidance on the implementation of ICP 24 (Macroprudential Supervision) and the Holistic Framework for the Assessment and Mitigation of Systemic Risk in the Insurance Sector (Holistic Framework). Macroprudential supervision of the insurance sector is an important part of the jurisdictional supervisory toolkit. This supervision should be proportionate to the level of risk the sector presents to the financial system and real economy with analysis anchored in the agreed transmission channels identified in the Holistic Framework. Macroprudential supervision should be conducted in a manner that is directly tied to macroprudential objectives, taking into account the important cost/benefit tradeoffs discussed in this response.

Overarching Comments

The Draft AP should better align with the interrelationship between ICP 24 and the Holistic Framework in order to reduce inconsistencies.

While we accept that the Draft AP (and any subsequent Application Paper) and the 2019 Level 1 Holistic Framework serve different purposes, they are very closely interrelated. Paragraph 3 of the Draft AP draws a very direct link among the Draft AP, ICP 24 and the Holistic Framework. The Draft AP is intended to interpret and provide practical guidance to supervisors on the implementation of ICP 24. ICP 24, in turn, is cited by the IAIS as a key element in the "move away from the previous binary approach … toward a proportionate application and enhanced set of policy measures" (see Paragraph 39 of the 2019 Level 1 Holistic Framework and Table 1). We strongly believe that the Draft AP should reflect the approach of the Holistic Framework and that the IAIS should resolve several significant inconsistencies between the two, as well as with ICP 24. Notably, the IAIS should more closely align the Draft AP with the Holistic Framework by:

- Establishing a clearer linkage between the macroprudential supervisory tools highlighted in the Draft AP with the key potential systemic risk exposures and transmission channels that are the foundation of the Holistic Framework. The Draft AP, in certain areas, makes high-level references to the exposure/transmission channel concepts of the Holistic Framework but does not integrate these concepts with the corresponding supervisory tools in a meaningful manner. Among other shortcomings, this makes it difficult to assess the degree of proportionality inherent in the Draft AP as the Draft AP does not establish a discernible relationship between the level of potential systemic risk (as determined through the exposure/transmission channel) and the corresponding macroprudential supervisory tools.
- Rebalancing the Draft AP to focus on sector-wide risk relative to individual insurer risk. The Draft AP does not adequately focus on sectoral risks with its significant focus on individual insurers. Relatedly, the Draft AP does not fully take into consideration the need for supervisory coordination to develop a group-level view of risk.
- Distinguishing more clearly between macroprudential oversight, aimed at potential systemic risk trends affecting the sector more broadly versus the microprudential oversight that is the basis for company-specific prudential supervision. Certain supervisory tools discussed in the Draft AP, such as stress testing, could have both macroprudential and microprudential applications and implications. The Draft AP should not inadvertently promote 'scope creep' or blur the boundaries between the objectives of macroprudential and microprudential supervisory objectives.

The Holistic Framework begins with a sector-wide analysis, consistent with the evolution from an approach in which policy measures applied to a small number of insurers to one that emphasizes sector-wide monitoring conducted by jurisdictional supervisors. We urge the IAIS to adopt the same sectoral focus in the Draft AP, as its focus is too institution-specific. Additionally, we encourage the IAIS to review ICP 24, in place of the current emphasis on institution-specific assessments.

To this end, we encourage the IAIS to focus the paper on practical guidance on how supervisors can establish sector-wide assessment frameworks that strengthen their ability to identify and respond to an activity of concern. Further, while we support jurisdictional implementation of the policy measures and tools underpinning the Holistic Framework, we believe that the IAIS should also provide guidance on how results of jurisdictional analysis could be shared across jurisdictions as well as where and how jurisdictions could coordinate activities as they may pertain to insurance groups with international operations. One example of supervisory action that we believe could strengthen the Draft AP is the review of insurers' investments in collateralized loan obligations (CLOs) that was conducted by the National Association of Insurance Commissioners (NAIC) in 2018.[1] The NAIC became aware of a steady increase in insurers' CLO exposures and conducted an *ad hoc* one-time review of this market development to determine the potential impact on the investment portfolios of U.S. insurance companies. The NAIC's Capital Markets Bureau concluded that CLO exposures represented a very small proportion of U.S. insurers' total assets and that these exposures generally were of high credit quality. This review of CLO exposures also revealed some double counting of exposures. The report did not suggest that a supervisory response was needed. Importantly, the CLO review did not involve or lead to an annual data call; rather, it was a targeted, limited

[1] http://www.naic.org/capital_markets_archive/special_report_190618.pdf.

study that responded to a specific market development to answer the question of whether supervisory intervention was needed.

Section 4.2.5 of the Draft AP calls for a cross-sectoral analysis that links the insurance sector with other parts of the financial system such as banks, funds, payment systems, and the public sector. Guidance on this cross-sectoral analysis could be better articulated in the Draft AP. Moreover, the concerns about the interconnectedness of the insurance sector with other financial services sectors should be tempered by the positive benefits of these interconnections (as discussed below)—benefits that would be revealed in a cross-sectoral analysis.

Finally, we also encourage the IAIS to reflect in the Draft AP that any assessment of systemic risk should be made at the group level by the competent authority. A clear statement by the IAIS of the need for a group level assessment led by the group supervisor is critical to avoiding multiple and/or inconsistent approaches to the assessment of and response to potential systemic risks in an insurance group or entity.

Reduced-form approaches are not appropriate for the insurance sector

The Draft AP errs by going beyond the Holistic Framework and ICP 24 with its endorsement of "reduced-form" approaches and methods for assessing the systemic relevance of individual insurers that have not been demonstrably linked to the transmission channels for systemic risk that the IAIS has identified. We urge the IAIS to refocus the Draft AP on a sector-wide macroprudential analysis, with adequate consideration of individual market specificities, and to reserve deeper focus on individual insurers for instances where sectoral analysis suggests that the activities of one or more firms may be contributing to systemic stress.

For reasons articulated in the discussion of *Assessing Systemic Importance*, below, we strongly recommend that the IAIS remove the discussion of reduced-form approaches from the Draft AP.

The Draft AP needs to better reflect the proportionality principle and an outcomes-focused approach

The Holistic Framework reaffirms the principle of proportionality and the outcomes-focused approach that underlie most IAIS Application Papers (see Paragraphs 41 and 42). However, the Draft AP does not adequately reflect this important principle and approach. We find the discussions of data collection and quantitative and qualitative analyses in the Draft AP to be prescriptive.

The Draft AP should refrain from inadvertently endorsing a particular tool or set of tools, as it may give supervisors the impression that their supervisory frameworks would not be adequately robust or complete without those specific tools. Similarly, the extensive discussion of indicators does not reflect that different indicators may be appropriate for different markets; moreover, some of these measures have not been tested across a full market cycle. While some microprudential tools play an important role in advancing macroprudential objectives, we encourage the IAIS to clearly define and delineate its guidance on macroprudential supervision and oversight, and to distinguish macroprudential supervision from microprudential supervision. The development of supervisory tools, whether microprudential or macroprudential, should be based upon a rigorous cost/benefit analysis that takes into account, and documents explicitly, the burdens imposed on both supervisors and insurers and the anticipated supervisory benefit(s) of the tool.

Supervisors should have the flexibility and discretion to design supervisory tools and to use indicators that best meet their needs and supervisory goals and that reflect the characteristics of the insurance market in their jurisdictions. Similarly, the wide range of practices introduced in the Draft AP should be positioned as a menu of options rather than an inventory of expected practices.

Cautions around a highly data-driven approach

The Draft AP reflects a highly data-driven approach that should be tempered with a greater emphasis on qualitative multi-factor approaches that reflect that market stresses may emanate from unexpected sources, as has been evident during the COVID-19 crisis. Financial statement information reflects a past state that may be markedly different from current conditions. The limitations of historical data have been highlighted in the current crisis.

The IAIS should advise supervisors about their responsibility to ensure that staff skilled in data and statistics are employed to interpret carefully the output of data from tools. Supervisors should be warned about the risks of using 'black boxes' that limit the supervisory view into how the underlying data was generated and from what sources, and how various data points were weighted. Supervisors should understand that tools and indicators that contain rapidly changing market data can produce false positives or incorrect predictions, lead to faulty conclusions as to causality and, ultimately, result in inappropriate supervisory actions.

Results and supervisory actions must be tractable. Some tools or indicators may have the advantage of providing snapshots of important metrics but have the disadvantage of not providing the full context that is needed for effective supervisory decision making. Certain indicators that are helpful at the entity level may not be as helpful, or can be misleading, when applied at the group level. The output of supervisory tools, indicators, and metrics should be considered as one of several factors in conducting macroprudential supervision in a holistic manner.

Data requests should be targeted and aligned, supported by robust cost/benefit analyses

Any request for data from individual insurers should be supported by a robust cost/benefit analysis in order to avoid burdensome/overbroad and multiplicative requests that may generate information of limited utility. Jurisdictional supervisors should take the lead in designing data calls, as they have a better understanding of what data is most valuable.

The IAIS should revisit its arrangements for receiving aggregated information from jurisdictional supervisors and develop protocols that can address any challenges of data sharing that could impede global supervisory coordination while recognizing and respecting that approaches across jurisdictions can and should vary in light of the heterogeneity of insurance markets. Targeted requests and effective supervisory coordination can help ensure that management's time and attention are devoted to operating the business, and supervisory attention is devoted to key risks, particularly during a crisis.

Comments on Specific Sections and Paragraphs

Data Collection for Macroprudential Purposes

As jurisdictions establish their macroprudential frameworks, which we encourage as key to the implementation of the Holistic Framework, the IAIS should seek to leverage to the maximum extent possible the work of the member supervisors in order to avoid requesting similar or multiplicative information that puts an undue and unwarranted burden on both insurers and supervisors.

The COVID-19 crisis revealed the significant value of workshops and discussions among supervisors and senior risk managers of insurance groups. These discussions can better reflect current market conditions and concerns and provide valuable forward-looking perspectives than can data calls that collect historical data and may quickly become stale. Workshops and discussions also allow for a focus on desired outcomes, rather than on data points. Stakeholder discussions can also help identify the risk factors that are most relevant to a particular sub-sector of the industry, region, or jurisdiction.

Assessing Systemic Importance

We agree with the statement in Paragraph 91 that off-balance sheet items should be judged holistically, and we would extend that concept to the whole of the balance sheet approach. A holistic approach should also encompass dialogue with senior management of the insurer in order to place the balance sheet analysis in the proper context and to better understand material recent developments that have impacted the balance sheet, either positively or negatively. A greater emphasis should be placed on the materiality of risks when supervisors conduct a balance sheet review. Supervisors should also understand how the insurer manages its assets and liabilities and what enterprise risk management or asset/liability management techniques and risk mitigants the insurer can employ to address any balance sheet stresses or risks described in Paragraph 90 (e.g. fire sale or credit risks). We also encourage a greater emphasis on inward risks in this paragraph, as generally they are more material for insurers than are outward risks.

We reiterate the comments we have made previously on the “limited substitutability (critical functions)” transmission channel.[2] Insurers conduct few, if any critical functions. While on rare occasions limited substitutability could be of systemic relevance to the insurance sector, we would not consider it a critical function in the same manner as, for example, the banking critical functions that are linked to the real economy and the money supply. Insurance markets are largely self-correcting; when a disruption occurs, insurance rates tend to harden due to lower capacity and increased risk premiums, and increased premiums in turn attract new sources of capital to the sector.

We do not agree with the statement in the final bullet of Paragraph 85 that global activity may be a proxy for the complexity of an insurance group. Neither size nor global activity should be seen as indicia of complexity or systemic relevance. We note that Paragraph 93 appropriately recognizes the risk mitigating impacts of geographic and economic diversification of exposures. We also point to Paragraph 40 of the

[2] See IIF Response of January 25, 2019 to the IAIS Public Consultation Document on the Holistic Framework, https://www.iif.com/Portals/0/Files/32370132_iif_systemic_risk_consultation_response_20190125_final.pdf.

Holistic Framework, which notes that size and international activity may work as risk amplifiers but do not necessarily correspond to whether an insurer is engaged in potential systemic activities or exposed to certain systemic risks. Indeed, geographic diversification, while increasing group complexity, may also act to significantly reduce an insurer's risk profile.

We reiterate our previous comments on the inappropriateness of deep haircuts or write-offs of securities issued by financial institutions (Paragraph 92).[3] The availability of these instruments as sources of liquidity should be analyzed in a risk-based manner. Broadly excluding these assets from a liquidity portfolio could have negative macroprudential ramifications, including impacts on the pricing and supply of certain types of assets, asset concentrations, and hoarding. Further, the exclusion of these instruments could have a negative effect on the financial sector and the real economy by disincentivizing insurers' investments in the debt of other financial institutions. Insurers also should not be constrained from using bank sources of liquidity, consistent with sound asset/liability management and risk management practices.

More broadly, the discussion in Paragraphs 92 and 93 should acknowledge the stabilizing nature of the insurance sector and the reality that insurers do not fail overnight. The Draft AP touches on these points briefly and indirectly in Paragraph 79, but does not leverage them throughout the document. The Draft AP would benefit from an explicit acknowledgement that insurance acts as a stabilizer in the event of idiosyncratic shocks or aggregated shocks (e.g. natural catastrophe). Insurers act as a major source of funding to the financial markets through their investments, much of which is patient, long-term capital. The role of insurers as market stabilizers has been amply demonstrated during the COVID crisis, most notably during the Q1 2020 market instability. Insurers support the products offered by the banking sector (e.g. through the provision of trade credit insurance). Insurance alleviates the fiscal pressures of government social spending by providing private sources of income to individuals impacted by the death or disability of a wage earner or to individuals and companies impacted by a natural disaster. The Draft AP should advise supervisors to conduct a careful analysis of the use of any proposed macroprudential tools or measures in light of their potential to undermine the important stabilizing role of the insurance sector. Poorly designed or inappropriately deployed tools and measures could have deleterious impacts on financial stability and the real economy.

In considering insurers' interconnections with the real economy (see Paragraph 99 and following), we encourage the IAIS to consider how the Draft AP reflects past guidance that the IAIS has issued. For example, some of the concerns around these interconnections may not be consistent with the positive tone around infrastructure investments that the IAIS expressed in a recent IAIS stock-take,[4] and may not align with initiatives from the G20 and other official sector organizations. Concerns about interconnectedness also do not reflect the positive contributions of insurers' connections to other financial services sectors and the real economy, and to financial stability as noted above.

[3] See IIF Response of February 4, 2021 to the IAIS Public Consultation Document on the Development of Liquidity Metrics: Phase 1 – Exposure Approach, https://www.iif.com/Portals/0/Files/content/Regulatory/02_05_2021_liquidity_metrics.pdf; and the IIF Response of January 22, 2020 to the IAIS Public Consultation Document on the Draft Application Paper on Liquidity Risk Management, https://www.iif.com/Portals/0/Files/content/Regulatory/01_22_2020_lrm_ap_response.pdf.

[4] See IAIS Stock-take Questionnaire on Infrastructure and Strategic equity, https://www.iif.com/Portals/0/Files/content/Regulatory/04_08_2021_IIF_response_IAIS_Stocktake.pdf.

We recommend a broader approach in Table 6 that also encompasses indicators of impact to the financial sector as well as to the non-financial and public sectors.

The cut-offs under the indicator-based approach (see Paragraphs 105 and 106) are overly simplistic as they do not allow for the consideration of the qualitative or discretionary judgment that is essential to a holistic analysis. They also do not appear to reflect the broader context of insurer and insurance group enterprise risk management and asset/liability management. Additionally, these scoring mechanisms do not provide for discussion with the management of the insurer, which can result in new or different insights into the amount of risk or systemic relevance reflected in a particular indicator.

Section 4 introduces new supervisory standards and guidance that disregards the framing that the IAIS has established for the role of Application Papers, as expressed in Paragraph 4.

Section 4.1.3 advances reduced-form approaches as methodologies for identifying systemically important insurers. Reduced-form approaches are inconsistent with ICP 24, which calls for the analysis of a full range of quantitative and qualitative factors when considering the potential systemic importance of an insurer (see ICP 24.3), and are also inconsistent with the Holistic Framework. Reduced-form approaches do not reflect the holistic approach to insurance sector analysis that is encapsulated in ICP 24.2 ("The supervisor, as part of its macroprudential supervision, performs analysis of financial markets and the insurance sector that: is both quantitative and qualitative; considers historical trends as well as the current risk environment; and considers both inward and outward risks.")

The apparent simplicity of reduced-form approaches masks the complex and volatile nature of these models.[5] Reduced-form models rely on market-related data and variables, and are econometric 'black box' methodologies typically managed by third parties that do not provide supervisors with control over or even the necessary insights into the underlying data or modelling techniques needed to make an informed decision as to their effectiveness and fitness for purpose.

It is important to understand thoroughly the drivers and sensitivities of reduced-form modeled outputs and the potential for these outputs to give rise to false positives and precision bias. Reduced-form models may also provide output that does not provide insight into performance over a full economic cycle. Reduced-form models were developed largely in response to the global financial crisis of 2007 to 2009 (GFC) and, therefore, might not be relevant in assessing different conditions or scenarios than those that prevailed during the GFC.

Reduced-form models generally attempt to predict when an event (e.g. a default) will occur but do not provide insight into the context or reason for the occurrence of the event and how the company will be impacted by the event. Reduced-form approaches may depend on assumptions that might not appropriately reflect an insurance group's financial condition, including its capital adequacy, leverage, and resolvability. Moreover, these models tend to focus exclusively on prospective capital-related impacts,

[5] The IAIS has noted the significant non-economic volatility inherent in these methods (see Paragraph 126).

whereas much of the Holistic Framework is appropriately focused on liquidity pressures as a potential systemic risk transmission mechanism.

Importantly, “reduced-form” approaches have not been demonstrably linked to the transmission channels for systemic risk that the IAIS has identified. Indeed, for reasons explained in the following paragraphs, reduced-form approaches have been challenged by economists because they are focused on capital shortfalls instead of illiquidity, and they lack the ability to differentiate key aspects of the banking and insurance models that are key to assessing any systemic threat.

SRISK in particular has been developed for the banking sector and is not appropriate for application to the insurance sector. The focus on the expected capital shortfall in the event of a prolonged market decline is misplaced in the insurance context because insurers rarely fail suddenly; rather, the presence of adequate liquidity to facilitate an orderly wind-down or exit from some markets is a more appropriate focus for insurers (and has been an important key focus of the IAIS). In the insurance context, different factors are more important (e.g. reserves) and some factors will be more relevant for P&C insurers and others more significant for life and retirement companies. Moreover, SRISK model outputs and rank orderings of firms over time are volatile.[6]

In a 2016 paper, which is attached for your convenient reference as Appendix A, Hal Scott of Harvard Law School and Oliver Wyman concluded that the SRISK measure is not appropriate for estimating and comparing the systemic risk of life insurers to that of other peer financial institutions.

The Scott paper states that SRISK does not provide the means to assess the potential for large insurers to potentially pose the same levels of systemic risk to the financial system as banks because it does not attempt to measure the ability of an institution to cause or transmit risk to the financial system or broader economy and because the metric relies on invalid assumptions (e.g. that an insurer would need to and would be able to rapidly de-leverage its portfolio under stress). SRISK does not measure the potential for an institution to transmit systemic risk because it only shows that an individual institution *could* be vulnerable to failure, while ignoring several key causation and transmission channels. It applies a uniform approach based on high-level publicly available data to the heterogeneous insurance sector and ignores the historical proof that distresses in insurers have not led to systemic consequences. Moreover, SRISK inappropriately uses market capitalization as a proxy for an insurer’s regulatory capital and strength, despite the fact that the study found that, historically, the risk-based capitalization of large U.S. insurers and their market capitalization failed to show any correlation in movement. (The Scott paper was focused on the U.S. insurance market.)

Another study from 2017 found that the SRISK methodology substantially overstates the systemic risk of Canadian insurers, in part due to the inclusion of segregated funds in insurance liabilities, which overstates leverage.[7]

[6] We understand that SRISK values for financial institutions are updated daily on New York University’s Volatility Institute website, http://vlab.stern.nyu.edu/welcome/risk.

[7] Analysis of the SRISK Measure and Its Application to the Canadian Banking and Insurance Industries, Global Risk Institute, http://globalriskinstitute.org/wp-content/uploads/2017/05/Adjusted-SRISK-FINAL.pdf.

As the IAIS acknowledges in Paragraph 112 of the Draft AP, coverage of reduced-form models, such as SRISK and conditional value at risk, or CoVaR, is limited to publicly traded insurance groups operating in deep and liquid equity markets. This poses a scope challenge, as these models would not apply to the sector-wide population under consideration, including mutual insurers, smaller insurance groups, operating subsidiaries or some groups operating in emerging markets or developing economies. In Paragraph 126, the IAIS also acknowledges such approaches "carry significant non-economic volatility which reduces the validity of the signal."

Given the significant shortcomings of reduced-form approaches, which the IAIS acknowledges, we strongly recommend that references to these approaches be removed from the Draft AP.

Insurance Sector Analysis

Supervisors should review the results of insurers' stress testing before conducting their own exercises. Insurers are better placed to understand and reflect in their stress tests the risks most relevant to the company. The results of stress testing should be interpreted carefully, using solid data analysis and contextual information to inform any supervisory conclusions.

It is important that the Draft AP acknowledge that, while uniform supervisory stress tests and scenario analyses may facilitate comparability, they are not well suited for pinpointing the material risks and exposures of individual insurer business models. The results of a uniform supervisory stress test should be reviewed in conjunction with company-conducted analyses and other company sources of information. As further discussed in our comments on transparency, the results of supervisory stress tests should not be disclosed publicly, as this could have destabilizing market impacts.

The timing of stress tests and scenario analyses is also important; when market stresses arise, insurers should first be permitted to address and manage the stress situation at hand without the additional burden of supervisory data calls, stress tests and scenario analyses. Furthermore, in the aftermath of market stresses supervisors can look to the real data sets generated by that event, as with the COVID-19 crisis, instead of relying on theoretical stress events.

Supervisory Response

We reiterate our call for greater dialogue among supervisors and the senior management of an insurer before adopting a supervisory response or taking supervisory measures. Rule-based automatic triggers (see Table 10) are particularly vulnerable to misapplication and should be avoided. Rather, the focus should be on the development of a toolbox of measures that can be applied with supervisory discretion after full consideration and discussion with management of the insurer regarding the circumstances leading to supervisory concern.

As noted in Paragraph 34 of the Holistic Framework, exposure to a vulnerability depends on how an activity is managed. Enhancements to enterprise risk management can best address risk management deficiencies at an insurer, and supervisors should be advised to direct management to develop those enhancements as a first response.

Restrictions on business activities and other intrusive measures detailed in Paragraph 161 should be a last resort in a ladder of intervention that begins with the least intrusive measures. We agree with the focus on insurer-led measures in Paragraph 162, as the insurer best understands its risk profile. We also agree with the need for the supervisor to document and communicate to the insurer the precise assessment of potential systemic exposures or activities that led to the requirement (Paragraph 163). The impact of supervisory measures on the insurer's ability to continue to meet policyholder needs under existing and new contracts should also be considered.

Transparency

We understand the need for transparency and reporting on the insurance sector, both to official sector institutions and to the general public, in order to instill and maintain confidence in the sector. However, caution should be taken to ensure that data is appropriately validated and aggregated in order to avoid harm to the market, to a company, or to a group of companies.

As was agreed by the IAIS during the development of the Holistic Framework, any information that would allow an individual company or group of companies to be identified should be omitted from publication in order to avoid market harm. This is especially important in the case of publication of the results of a systemic importance assessment or of measures taken in relation to a distressed insurer. Publication of information that could result in the identification of a company or group of companies could have a dangerous destabilizing impact on the insurance market (and broader capital markets) as a result of market participants' uncertainty over the implications for their investments. It is likely that markets would overreact and adopt a worst-case scenario interpretation of the information that would aggravate, rather than address, the underlying supervisory concern.

The decision-usefulness of the information intended to be published should be considered when making a determination as to whether to publish insurance data, as well as the potential burden on supervisors and insurers.

We appreciate the opportunity to comment on the Draft AP and we are happy to provide any further context for or elaboration of our response.

Respectfully submitted,

Mf Monroe

Mary Frances Monroe

Attachment: Appendix A