Position Paper

Insurance Europe comments on IAIS proposed methodology for identifying systemically risky insurers

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I. Introduction

1. Insurance Europe recognises that all financial sectors, including insurance, should be assessed for their potential to pose systemic risks, in order to facilitate the protection and development of a stable and sustainable international financial system. In this regard, we welcome the work conducted by the IAIS in this area in recent years and appreciate the opportunity given to comment on the draft methodology.

2. There is little evidence of traditional insurance either generating or amplifying systemic risk within the financial system or real economy. We welcome the IAIS recognition of this in its November 2011 report '*Insurance and Financial Stability*' (IFS) and in paragraphs 7 – 19 of the consultation document. We support the IAIS's conclusion (paragraph 18):

"In summary, neither long experience of insurance markets nor information arising from the global financial crisis provides any evidence of traditional insurance either generating or amplifying systemic risk within the financial system or in the real economy. The potential for systemic importance is only considered to arise in any non-traditional or non-insurance activities which may be undertaken by a small number of insurers."

3. We regret that this position is not sufficiently reflected in the proposed methodology, which is based on the indicator-based approach applied by the Basel Committee on Banking Supervision for banks and as a result does not reflect the significant differences between business models in the two sectors. In our view, in insurance the focus should be on specific activities that can generate systemic risk, not on individual institutions.

4. Moreover, as stated in the IAIS November IFS report *"non-insurance activities are not necessarily systemically important"*. This is an important conclusion; just because an activity is 'non-traditional' or 'non-insurance' does not mean that it should be regarded as systemically risky. For instance, third party asset management is included as a non-insurance activity, however as the IAIS acknowledges in paragraph 17, it is not to be considered as posing a systemic risk.

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5. The proposed list of systemically risky non-traditional non insurance activities (NTNIA) is too lengthy and includes activities that do not pose a systemic risk. We suggest that the IAIS methodology incorporates a narrower and more precise list of NTNIA; otherwise insurers may be incentivised to exit/cease legitimate business activities and investments to avoid being determined as systemically risky.

6. If the list of NTNIA is reviewed and it targets activities which can generate or amplify systemic risk, Insurance Europe believes that the indicator methodology should focus on activities in this category. We question the inclusion of categories (e.g. size, global activity) and indicators (e.g. reinsurance and intra financial assets) in the methodology which enhance an insurer's financial stability, rather than posing systemic risk.

7. We welcome IAIS proposal to complement its indicator-based approach with a business segmented assessment (the IFS approach). This could become a useful analysis of systemic risk in insurance and an important element for the assessment of insurers and for the screening process of insurance activities. However, some aspects of the IFS approach, such as the arbitrary segmentation into traditional, semi-traditional and non-traditional insurance activities, remain unclear and further clarification is needed on how this approach will work in practice. For example we do not agree with the classification of trade credit insurance as semi-traditional, as it meets all the criteria of traditional insurance business as suggested by the IAIS in their November 2011 publication "Insurance and Financial Stability". We believe the IFS approach should target activities that have the potential to contribute to systemic risks (rather than the current broad scope of NTNIAs). We encourage the IAIS to develop this approach further and to give it a more significant role in the assessment process.

8. We believe that it is inappropriate for the methodology to make comparisons using data reported by other insurers only. The IAIS methodology's intention is to identify insurers whose distress or disorderly failure will cause significant disruption to the global financial system. Evaluation of systemic risk requires the extent of an insurer's involvement in a systemically risky activity to be compared with the wider financial markets, not just a select group of insurers.

9. We agree with the IAIS's intention of comparing the aggregate systemic risk posed by the insurance sector with that posed by the banking sector. To ensure that this is a fair and accurate comparison, Insurance Europe believes that the cut-off point to determine which institutions are classified as GSII's should be based on the extent of an insurer's involvement in NTNIA. Compiling a list of systemically risky insurers without differentiating between their traditional activities and NTNIA contradicts the IAIS position on insurance and financial stability to date.

10 We believe that the IAIS should consider an alternative approach. As traditional insurance activities are not sources of systemic risk, the focus should be on NTNIA. We therefore suggest the following process for identifying and managing systemic risk:

a. Firstly, a screening process to identify companies involved in systemically risky NTNIA. This process would apply relevant categories (such as size, interconnectedness, time and substitutability) and metrics exclusively to such activities, to identify whether the conduct of the activities is of systemic relevance.

b. Secondly, application of measures targeting activities considered to be systemically relevant, taking account of mitigating factors and existing legislation.

11. We appreciate the IAIS desire for a level playing field and a consistent international approach in dealing with potential G-SIIs. However, existing diversity in national/regional supervisory approaches and regulatory requirements must not be overlooked. Financial stability will benefit if regional differences in meeting common goals are maintained.

12. It is important to ensure that dangerous gaps in regulation are identified and dealt with. Effective structural and prudential measures in a supervisory framework are necessary. Europe's revised supervisory architecture (the European Systemic Risk Board (ESRB) and the three new sectorial authorities, including the European Insurance and Occupational Pensions Authority (EIOPA) for the insurance sector) paired with Europe's experience of group supervision should ensure that potential material risks are identified. A group supervisor will be well-positioned to ensure that new measures carefully focused on the potentially risky activities identified can be introduced in a risk based manner, in line with prudential measures contained in regimes such as Solvency II and the Swiss Solvency Test.

13. Despite our preference for the proposed alternative approach, the following sections contain a number of comments on the proposed methodology and envisaged measures.

II. Assessment methodology for systemic importance of G-SIIs

13. Insurance Europe's main concern about the proposed methodology is that it is not consistent with the IAIS's own assessment of the potential sources of systemic risk in insurance, as detailed in paragraphs 7-19 of the consultation document and in its November 2011 paper "*Insurance and financial stability*". The proposed methodology may result in a list of G-SIIs insurance companies involved in traditional activities, even though such activities do not generate systemic risk. Several amendments to the proposed methodology are required, to avoid such a situation.

14. The IAIS should carefully consider the incentives and unintended consequences which may result from the selection of certain indicators or categories in its methodology. Inclusion of an indicator relating to 'derivatives' in the interconnectedness category is a good example of this. Derivatives play an important role in effective insurance risk management. This function is being increasingly reflected in certain prudential risk based regimes such as Solvency II or SST which encourage Insurers to mitigate risk through the prudent use of derivatives. The inclusion of an indicator related to derivatives could result in insurers choosing to retain a larger portion of risk themselves which would contradict what the IAIS process is trying to achieve. Another example of unintended consequences is provided by the indicator 'intra-financial assets'. Some companies could decide to take action to avoid being included as a G-SII by selling certain assets. Such an operation, if conducted on a massive scale by several companies at the same period of time, could have important destabilising effects in the markets.

<u>Categories</u>

15. The size factor is given excessive importance by IAIS proposed methodology, as it is used in three different instances:

1. As an initial filter for the sample;
2. As a specific category; and
3. Indirectly, in other indicators in different categories.

This focus on size introduces a considerable bias to the results of the identification process. In order to avoid an insurer's size determining its systemic relevance, we suggest it is used in the initial filtering process only. This would reconcile the need to establish a starting point for considering the relative systemic relevance of insurers with the consideration that size plays a positive role in effective risk management of traditional insurance activities.

16. We also disagree with the inclusion of the categories of "global activity" and "substitutability". The IAIS acknowledges (Par 8) that "*the risk profile of an insurer becomes less risky the more risks are assumed, i.e. the larger it is and the more diversified its business is*". This applies to global activity as it does to size. The methodology should not include substitutability, as the failure of a specific sectoral insurer will not trigger a systemic event. It is important that the difference between 'substitutability' and 'un-insurability' in the insurance sector are properly understood. The latter is the result of an appropriate economic assessment

following a change in market conditions. In defining substitutability the IAIS refers to classes of traditional insurance (marine and aviation). It should justify the basis on which these have been picked out. We believe that a gap in coverage relating to such traditional insurance activities may, in exceptional circumstances, cause a temporary disruption in a particular economic sector, but is not a systemic event. This contrasts with the banking sector, where a disruption in key infrastructure (e.g. the payments system) has an immediate systemic knock-on effect on the global financial system and economic activity.

Indicators

17. We do not agree with the inclusion of an indicator relating to insurers' intra financial assets, due to the potential effect this might have on insurers' investment activities. We would also make this argument in respect of the inclusion of an indicator relating to 'large exposures'. The long term investment horizon of the insurance business model makes a fire sale of assets highly unlikely and can provide stabilising effects to the wider financial markets especially in times of distress.

18. We are concerned by the inclusion of "reinsurance" as an indicator. This indicator contradicts IAIS conclusions in its recent report 'Reinsurance and Financial stability' that *"traditional reinsurance is unlikely to cause, or amplify, systemic risk""*. It also contradicts paragraphs 15 and 16 of the consultation document, which note that reinsurance is a traditional insurance activity and that reinsurers are a source of stabilisation. A G30 (2006) study "Reinsurance and International Financial Markets" also concluded that reinsurance should not be considered systemically relevant. We question whether there is any significant level of interconnectedness within the reinsurance market, as the percentage of premiums ceded is insignificant (circa 7%) from a financial stability perspective. We consider that reinsurance should be removed from the interconnectedness category.

19. We query the inclusion of an indicator related to variable annuities in the NTNIA section. We regard variable annuities as being a traditional activity and not a source of systemic risk. The classification of variable annuities as an NTNIA is in contrast to their classification under the IFS methodology, where they are included as a "semi-traditional" insurance activity. The financial crisis of 2008-09 provided a 'stress test' of the difficulties of providing guaranteed returns to policy holders in a situation of significant market stress. Insurers effectively managed their exposure to the product and there was no evidence of an 'acceleration of asset sales to pay guaranteed amounts' as suggested by the consultation. We strongly urge the IAIS not to include variable annuities as an indicator.

20. We also query the inclusion of an indicator for "intra-group transactions" in the NTNIA category. Intra-group transactions may increase the complexity of an insurance group, but are by themselves not a source of systemic risk. Internal transactions with non-insurance group entities conducted in support of traditional insurance business should also not be incorporated as an indicator.

21. If the final methodology includes an indicator related to the liquidity of insurance liabilities (paragraph 34) this must take into account the specificities of the insurance market. Factors such as tax penalties and the inability of policy holders to replace contracts with the same conditions have a significant impact on the possibility of an "insurance run". On the other hand we think that the proposed derivative indicator suggested in paragraph 34 could, if well-defined and if focused specifically on NTNIA, have the potential to be appropriate for the final methodology.

Process

22. We think that the IAIS should compare an insurer's results/figures for a specific indicator with the respective figures for the whole financial system for that indicator. This approach has the following advantages:

- It reflects the fundamental purpose of the methodology: to identify insurers whose distress or disorderly failure would cause significant disruption to the global financial system and economic activity, rather than simply identifying those with a presence in particular areas that is relatively greater than that of other insurers in the sample.

- It reduces the risk of an insurer receiving a high riskiness score if only a few insurers included in the study are engaged in a particular activity. For example, if there are twenty insurers reporting numbers for the indicator on short term funding, then each institutions individual reported figure will be divided by the sum of the twenty institutions reported figures. An individual institution's score will then be applied to the risk weights ascribed to the indicator by the methodology (6.7%-8.3% in this case). In contrast if only four or five institutions report figures for the derivatives indicator, then the score as calculated on the same basis as the short term funding indicator will be much higher.
- It limits the unintended consequences of insurance companies taking actions specific to certain indicators in order to achieve a lower ranking in the pool. An example here would be if insurers were to limit their investment in or exposure to particular kinds of assets/liabilities which could have a potentially disruptive effect on certain markets.

23. Insurance Europe would welcome further details of how the IAIS proposes to effectively reconcile the use of diverse accounting standards in the calculation of the proposed indicators. It is not clear in the document whether the IAIS will take into account the effects from different accounting regimes (SAP, US GAAP and IFRS) in order to ensure that the numbers provided by different groups/entities are effectively comparable.

24. Insurance Europe understands that the IAIS will use the assessment methodology to enable a comparison of an insurer's relative exposure to systemic risk. Paragraph 44 says that the IAIS may compare the top-ranked insurers with the 29 identified G-SIBs. We welcome a comparison between companies and sectors in terms of their systemic relevance; however, it is difficult to see in practice how the proposed methodology enables an effective comparison between both insurers and across different financial market sectors. In our view, comparisons based on indicators calculated on an absolute value basis will be limited to measuring the relative size of one institution to another and are not necessarily appropriate in assessing a particular institution's systemic relevance. As Insurance Europe has previously remarked on a number of occasions, size means very different things to insurers and banks.

25. Insurance Europe welcomes the existence of additional qualitative and quantitative assessments, including supervisory judgement (Paras 45 - 53). The IAIS should provide further clarification of the role of the IFS assessment in this process. The assessment should take into account existing and future supervisory/regulatory frameworks as well as other mitigating factors (e.g. effective risk management and ART, reinsurance, use of derivatives for hedging).

26. Insurance Europe welcomes recognition of the possibility for group or other supervisors to challenge the findings of the assessment methodology (paragraph 51). We consider that the group supervisor is best placed to consider the relative riskiness of an insurance entity and that the role of the group supervisor in the assessment process should therefore be further expanded to include decision making powers. In this regard, we consider that the group supervisor should be granted a veto role. The supervisory judgement in this process has to be applied in a consistent and transparent manner across jurisdictions.

27. The methodology, as set out in the consultation document, lacks transparency. It does not mention any interaction between those carrying out the assessments and the insurers being assessed, nor does it say whether the insurers will have the opportunity to challenge decisions made "behind closed doors". It is important to establish a three-way dialogue between the IAIS, the group supervisor and any insurer classified as a G-SII. This will provide insurers under assessment with opportunities to ensure that information is correctly and accurately collated and interpreted and provide clarity on the reasons why an insurer is determined to be a G-SII. The IAIS should acknowledge the need for a process whereby the institution classified as a G-SII can challenge the decision by means of an appeal process.

28. We would welcome clarification on which body will be responsible for the collection, use and storage of the data used to identify G-SIIs. The suggested indicators incorporate data which is material non-public information. The IAIS must ensure that data remains confidential.

III. Policy measures for G-SIIs

29. Insurance Europe will make more detailed comments on policy measures in response to the separate consultation, planned for later this year. At this stage, we would express our concern that the envisaged measures target individual institutions, not specific risky activities. In our view, such an approach is unlikely to address the specific potential systemic risk-related concerns identified.

30. A set of measures targeted only at insurers designated as G-SIIs will create an un-level playing field between the identified G-SIIs and other insurers. The application of different rules to systemically relevant institutions is based on the FSB rationale that the resolution of such institutions would not happen in an orderly manner and that these entities therefore benefit from implicit public support. This is a process that is particular to banks, whose failure has significant impacts on the wider economy, through channels such as the payments system and supply of credit, so the use of different rules is justified. The same dynamic does not exist in insurance. If a particular activity in which insurers are engaged is judged to be risky, then the activity should be appropriately regulated, rather than applying measures to a cohort of larger institutions.

31. The imposition of a Higher Loss Absorbency (HLA) regime on the insurance industry will not be effective or practical for the following reasons:

- The role played by capital is very different in insurance than in banking. In the case of traditional insurance activities, funding is up-front and long term, based mainly on premiums paid by policyholders. Insurers generally have a simple and stable balance sheet where assets and liabilities are appropriately matched and have a high incentive to assess and price risk properly. Insurers also operate with significantly lower leverage ratios than banks. As a result, traditional insurers do not need the additional capital buffer banks need as a line of defence against a run or a sudden deterioration of financing conditions in the markets.
- As acknowledged by the IAIS, there is no global basis for adopting capital add-ons in insurance. Insurance regulation is about setting capital requirements commensurate with an insurers' risk profile in order to protect policyholders' interests. This risk-based approach, as provided by Solvency II, ensures that those activities that present a higher risk are already likely to be subject to higher capital charges. Additional capital charges, over and above risk based capital charges will likely result in higher risk protection prices, lower risk coverage and scarcer and more expensive funding for insurers. This would have a significant impact on insurers' ability effectively to price risk.

32. The imposition of capital charges at a global level on insurers is not only at odds with the role of capital in the insurance business model but would introduce moral hazard, whilst simultaneously distorting competition between insurance companies. Insurance Europe therefore proposes that a capital surcharge should only be envisaged for systemically risky non-insurance activities which have the potential to trigger a systemic reaction and where they are not adequately captured at national or regional level.

33. Any measures applied should take into account the diversity of national/regional regulatory frameworks as well as other mitigating factors, such as the presence of contingency plans, orderly wind-up processes or enterprise risk management, among others. Measures cannot be simply added at a global level to existing regional/national regulation or supervision, without a thorough comparability assessment of measures already in place.

34. Comprehensive group supervision at a consolidated level has been identified as an important measure to address systemic risk concerns. Insurance Europe agrees and supports this conclusion. To ensure that dangerous gaps in regulation do not result, there is a need to introduce and promote the role of a group lead

supervisor in insurance, with a total balance sheet view on all the activities conducted by a group and supported by a strong supervisory college. In this respect, the European insurance supervisory framework is already well advanced (under existing Insurance Group and Financial Conglomerate Directives and on-going Colleges) and will be further strengthened with the implementation of Solvency II.

ANNEX 1: Comments on proposed IAIS indicators

1. Size

Insurance Europe agrees with the IAIS recognition that the risk profile of an insurer becomes less risky the larger it gets. We would therefore question the proposed use of a "size" indicator, which in our view, cannot effectively capture an entity's systemic relevance. As well as constituting a specific category, size is a filter for the selection of undertakings to which the IAIS will apply the methodology and for indicators in other categories, making it a disproportionately significant factor. The focus on simple balance sheet metrics, such as total assets, for assessing size is inappropriate as it does not differentiate between an insurer's traditional activities and its non-traditional and non-insurance activities (NTNIA).

Proposed action: The category of "size" should be removed from the methodology. Size should be used in the initial filtering process only. If the IAIS considers it necessary to retain size as a category, it should focus on the size of systemically risky NTNIA.

2. Global activity

Insurance Europe is concerned by the proposed "global activity" indicator, which does not recognize the risk diversification benefits that result from conducting activities in various jurisdictions. An insurer may derive a significant proportion of its revenues from outside its home country and may operate in several different countries, but its market shares in each of these countries may be small. On the other hand, by sourcing its revenue from a multiplicity of locations, it is better protected from the consequences of local or regional economic downturns and catastrophic insured events. A globally active insurer may therefore be less systemically risky than an insurer with a more concentrated geographical presence, both in terms of likelihood of distress or failure and of its consequences.

Proposed action: The category of "global activity" should be removed from the methodology.

3. Interconnectedness

Insurance Europe agrees with the IAIS assessment that the degree of interconnectedness is generally much lower in insurance than in banking. The high degree of interconnectedness that characterizes the banking sector is due to the fact that banks engage in maturity transformation, where assets are of a longer duration than liabilities. This situation obliges banks to engage in a certain degree of short-term inter-banking lending and borrowing. As a result, the problems faced by one entity can in certain circumstances turn out to be an issue for other entities. The situation is different in insurance, given that insurance firms do not engage in maturity transformation and as a consequence do not need to engage in a high volume of short term borrowing. However, the methodology applies a higher weighting to the interconnectedness category (30% - 40%) than the Basel Committee on Banking Supervision's methodology for banks does (20%). If interconnectedness is less important in insurance than in banking, the weighting should be lower.

The IAIS approach should target those cases of interconnectedness which pose a real risk to the financial system.

i) Intra-financial assets

Insurance Europe does not agree with the rationale for including the indicator, as unlike banks, insurers do not engage in short-term lending to other financial entities. Rather, insurers invest in bonds and shares issued by banks as part of their long-term investment policies, to match their long-term liabilities. Far from being a source of systemic risk, such an approach by insurers contributes to shock absorption in financial markets. Including holdings in financial assets as an indicator of systemic risk could encourage firms to limit their exposure to such assets, which could have a destabilising effect in markets.

Proposed action: This indicator should only include those intra-financial assets which are part of an insurer's NTNIA. This distinction would help target real areas of systemic risk, without incentivizing insurance firms not to invest in financial assets.

ii) Reinsurance.

Insurance Europe welcomes the IAIS acknowledgment in paragraphs 15 and 16 of the consultation that reinsurance is considered part of traditional insurance activities and that it does not generate similar risks to the interbank market, the collapse of which was an important source of contagion in the recent financial crisis. It also welcomes the IAIS conclusion in its recent report "Reinsurance and Financial Stability" that "traditional reinsurance is unlikely to cause, or amplify, systemic risk. Furthermore, the IAIS position paper on Reinsurance and financial stability clearly states that there is no systemic risk originating from traditional reinsurance and some parts of the non-traditional reinsurance, for example finite reinsurance transactions with risk transfer (par. 67). Insurance Europe is therefore concerned by the proposed inclusion of a "reinsurance" indicator, when the IAIS has concluded, on the basis of detailed assessment, that reinsurance does not constitute a systemic risk. This indicator, which is an absolute value of reinsurer technical provisions, does not enable effective comparability between large and small reinsurers.

Proposed action: The reinsurance indicator should be removed from the methodology.

iii) Derivatives.

Insurers, like other corporate entities, enter into derivative contracts to hedge against day-to-day risks to income streams, resulting from e.g. exchange rate or interest rate risk. Such contracts are vital in 'locking in' prices and ensuring stability and predictability of revenues and expenditures. We assume that it is not the IAIS intention to capture such activities, which aim at limiting the risk exposure of an entity. However the current definition of the indicator will capture derivatives used for hedging purposes.

Proposed action: Derivatives used for Hedging and ALM purposes (including use of derivatives to replicate investment portfolios) should be excluded from the final indicator methodology.
If the indicator is to be considered a consistent and robust indicator of interconnectedness, and of the relative systemic risk of an insurer, then it should be reported net of collateral rather than as a gross figure. The inclusion of an indicator related to derivatives could result in insurers choosing to retain a larger portion of risk themselves which would contradict what the IAIS process is trying to achieve.

iv) Large exposures

This indicator is concerned with size, especially (a), which is just an addition of the 10 largest exposures. It therefore duplicates the methodology's first category. We therefore suggest focussing on (b).
The indicator should exclude assets held as part of traditional insurance business, such as sovereign bonds. We would caution against including holdings of sovereign debt in the indicator.
Proposed action: The large exposures indicator should focus on the indicator (b).

v) Level 3 assets

The total value of level 3 assets in itself provides no useful measure of potential systemic risk, as it does not incorporate any assessment of the significance of that sum in relation to the total market for such assets - or of the interaction between assets and liabilities within the business, or of the long term nature of insurance business which make the circumstances that might give rise to the need for a fire sale of assets extremely unlikely.

Proposed action: Any indicator focussing on Level 3 assets should incorporate only those assets held in relation to specified potentially systemically risky "non-traditional and non-insurance activities".

4. NTNIA

i) Non-policy holder liabilities and non-insurance revenues

Insurers, like other corporate entities, generate a portion of their incomes from outside their primary business lines. It does not necessarily follow that revenue diversification is a source of systemic risk. The ratio suggested by the IAIS would also capture revenues which are clearly not related to systemic risk (e.g. from third party asset management).

Proposed action: The calculation of total revenues from non-insurance businesses should be limited to revenues from NTNIA. This will ensure greater consistency in the IAIS methodology and ensure that non-risky traditional insurer activities are not inappropriately incorporated into the indicator.

ii) Derivatives trading.

Insurance Europe suggests a refinement of this indicator. It should include the gross notional amount of naked Credit Default Swap contracts only (i.e., where there is no ownership of the debt of the underlying reference entity). CDS contracts are routinely used by insurers as part of integrated hedging strategies related to the matching of assets and liabilities.

Proposed action: indicator should only include the gross notional amount of 'naked CDS' and trading for speculative purposes.

iii) Short term funding

Insurance Europe suggests that:

a) The first element of the indicator is reported net of the cash position. This will ensure that the indicator accurately reflects the liquidity position of the reporting entity.

b) Figures for securities lending and repo transactions are reported net of collateral rather than on a gross basis. This will ensure that the indicator captures the underlying economic value of any transaction undertaken by an insurer.

Proposed action: Indicator should be reported net of the firm's cash position and figures for securities lending and repo transactions should be reported net of collateral rather than on a gross basis.

iv) Financial guarantees

Insurance Europe questions the inclusion of sub-indicator (b) which relates to mortgage guarantee insurance. Mortgage guarantee products offered by insurers can differ across countries. In this regard it is not easy to arrive at a consistent understanding of what

constitutes a mortgage guarantee product and how the exercise of the product could be linked to the economic cycle.
In this regard, we would suggest that mortgage insurance products not correlated to the economic cycle (e. g those related to disability, mortality or sickness of the mortgage holder) are not included in the category

v) Variable annuities

Variable annuities do not involve a guarantee or obligation to other financial institutions and as a result do not increase systemic risk.

Including variable annuities as an indicator contradicts the classification of variable annuities as a semi-traditional insurance activity under the IFS assessment-based approach. Confusion regarding the appropriate classification of variable annuities could be because they share many characteristics with other life insurance products; for example the counterparty of the insurer is the policy holder, a retail customer.

The rationale provided by the IAIS is based on a rather hypothetical worst case scenario. The financial crisis during 2008-09 constituted a significant 'stress test' of insurers' ability to provide products with guaranteed returns in a falling market. Insurers effectively managed their exposure to these products and the lessons learned have been incorporated into a new generation of variable annuity products with lower rates of guaranteed growth, of protracted withdrawal values and pay out rates. Insurers have also put increased emphasis on investment in index-based funds, which ensures that returns on products offered better reflect actual market returns. Variable annuities and associated risk management activities are subject to comprehensive supervision in Europe, which will be further strengthened by the introduction of Solvency II.

Proposed action: The "variable annuities" indicator should be removed from the methodology

vi) Intra-group commitments

Insurance Europe considers that Intra-group transactions may increase the complexity of an insurance group, but are not themselves a source of systemic risk. The definition of intra-group commitments should be targeted on those related to NINIA. Intra group transactions that support normal traditional insurance business should not be included.

Proposed action: The indicator should be limited to NTNIA-based commitments.

5. Substitutability

Insurance Europe questions the relevance of the combinations which make up the 'substitutability' category. The proposed indicators unnecessarily incorporate traditional insurance activities into the assessment process. Trade credit, marine and aviation insurance all fulfil the criteria for traditional insurance business outlined in the IAIS November 2011 report, "Insurance and financial stability".

Use of a measure of absolute value does not differentiate between the lack of substitutability of a product and an un-insurable risk. There have been situations in the past where the provision of certain insurance products became difficult, either because of the failure of an insurer with a large market share or because of individual decisions by a number of insurers not to continue to offer the product in question. Any disruptions arising were temporary and were based on the existence of significant uncertainty which impaired effective pricing of the activity in question.

Proposed action: The category of "substitutability" should be removed from the final methodology.

If, however, the IAIS persists in including this category in the methodology, it must provide better justification for its selection of classes. In other words, it must give evidence backing its assertion that credit, marine and aviation are all "significant and highly concentrated markets in a global context" and that they are more significant and concentrated than other classes not selected. The IAIS must also define precisely what is included in the classes that they specify, as class definition is not straightforward and varies across jurisdictions. In particular, relevant substitutes available for the included product lines would have to be taken into account – e.g. in case of trade credit insurance this would be inter alia factoring.

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