Position Paper

Insurance Europe response to the IAIS consultation on non-traditional, non-insurance activities and products

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Key messages

- **Insurance Europe welcomes the opportunity to contribute to the IAIS work on the identification of non-traditional, non-insurance (NTNI) activities and products. It appreciates that the consultation document proposes a multi-stage process which is required in order to arrive at an appropriate assessment of activities that have an actual potential of systemic risk.**
- **The identification of vulnerabilities and the inclusion of an assessment of transmission channels is important to recognise that vulnerabilities will, in many cases, not result in actual transmission of systemic risk. Such an outcome is sensible when the vulnerabilities have the potential for a too small impact on the financial system and the real economy or/and because the transmission channels do not exist or simply do not lend themselves to propagation of vulnerabilities.**
- **However, as with the development of any framework, appropriate design and calibration of the framework are key, including a focus on not overestimating the vulnerabilities by ignoring risk-mitigation tools and management and supervisory actions. Insurance Europe can see how a framework correctly developed from this starting point could provide global supervisors and regulators with the assurance that they have correctly identified and can monitor any increases in such activities.**
- **It is important that the macro-prudential nature of systemic risk is more adequately recognised by the IAIS and reflected in its approach to defining measures targeting systemic risk. A clear distinction between macro- and micro-prudential tools should be made in the framework. In the current proposal, some elements are in many cases already addressed by micro-prudential regulation and supervision. For example, the existence of institution-specific vulnerabilities in itself does not create systemic risk and vulnerabilities are addressed by robust micro-prudential regulation.**

The vulnerabilities identified by the IAIS (ie market and liquidity risk) can and are in many cases already addressed by the micro-prudential framework, so the IAIS work on NTNI should only focus on residual risk, which is not addressed by the micro-prudential framework and which can lead to systemic outcomes with a

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potentially significant impact on the economy. What is missing is a global sector-wide, or possibly a financial system-wide, view of vulnerabilities and contagion channels, and a systemic risk framework to address them.

In addition, Insurance Europe does not support the IAIS approach on derivatives as it believes that the risk identified by the IAIS, ie the loss of derivative hedging in a stressed market, will lead to a balance sheet risk for the insurer but that this should be addressed by a risk-based micro-prudential framework and not by regulation of systemic risk.

- **While it is sensible that the identification of NTNI products and the level of systemic risk of NTNI products is led by the national authorities, this exercise should be based on the framework set out by the IAIS. It is imperative that national supervisors work closely together to ensure full consistency in the establishment and application of the internationally defined framework. Consistency in application and implementation should be further tested by the IAIS in the recalibration of the Basic Capital Requirement (BCR) and the Higher Loss Absorbency (HLA).**

Insurance Europe welcomes the IAIS approach of creating an analytical framework for NTNI, including principles based on which insurance products across jurisdictions should be classified. It believes that the identification of products and features that can give rise to systemic risk should be left to national supervisors, as they have the knowledge and understanding of their own markets. The national and regional market knowledge must be shared globally through the IAIS to establish a common international framework and ensure its consistent application. The consistent application of the analytical framework across jurisdictions should be tested in the process of recalibrating the BCR and the HLA.

- **The analytical framework does not sufficiently emphasise the role and importance of both management and supervisory action in reducing the systemic impact of NTNI. This element should be separately included and considered as part of both the analysis of both vulnerabilities and transmission channels. The systemic consequences should be assessed only based on residual risks.**

For example, supervisors can intervene to prevent a liquidity problem arising from mass surrenders and avoid transmission of risks to the financial systems.

- **The proposed approach for assessing liquidity risk is incomplete and does not fully capture the interaction between contractual features relating to surrender options and other elements such as management and/or supervisory actions; policyholders' assessments of costs and consequences of surrender; and the presence of guarantees.**

The existence of the possibility for supervisory and/or management actions should be included as a separate factor, as such actions can be used to minimise liquidity risk. More specifically, in many cases insurers have the contractual ability to delay surrenders and/or resolution authorities have the power to apply temporary stays. In fact, it is no coincidence that in market where products have flexible surrender options supervisors have the power to intervene.

The decision to surrender is not straightforward for policyholders and this can create a significant disincentive to surrender. Policyholders are in fact faced with uncertainty as they will need to weigh up whether they are ready to lose valuable benefits/guarantees that are only payable at specified contractual events, to be faced with tax implications that they had not planned for, to incur additional costs in securing alternative provisions, to require advice which may be difficult to find and costly, etc.

In addition, the existence of guarantees will create an extra disincentive for policyholders to surrender and guarantees should in fact be considered when assessing liquidity risk.

- **The design of the framework seems to over-weigh the importance of liquidity risk, but capital is not a tool to manage liquidity risk in the insurance sector.**

Over-weighing liquidity risk in the NTNI identification would lead to a capital add-on (ie the HLA) largely targeting liquidity. In the insurance sector capital may be an answer to a solvency issue, but not to liquidity, so the framework should avoid an implicit capital charge for liquidity risk.

- **The liquidation of assets can have an impact on both the financial position of the insurer and financial markets overall. The former should be dealt with under micro-prudential regulation and should not be part of the systemic risk framework. The assessment of the latter should be refined to reflect both whether policyholders have the choice of asset allocation and the liquidity management by the insurer.**

Insurance Europe supports the IAIS assessment that unit-linked products without guarantees pose no market risk and should therefore be removed from the list. In addition, unit-linked products where policyholders entirely bear the investment risk do not expose insurers to liquidity risk if the investments are clearly allocated to the policyholder, no investment guarantees exist or guarantees expire fully in case of surrenders.

In cases where policyholders have the choice of asset allocation, the issue is not insurance-sector specific and one can argue that the same investment choices would have been made via another intermediary or directly by customers. Therefore, penalising insurers will not reduce systemic risk.

In cases where insurers have discretion over the asset allocation, and where micro-prudential risk-based supervision foresees liquidity management requirements, the exposure to forced sales of assets will be significantly reduced.

- **Insurance Europe objects to the IAIS approach on derivatives and it believes that the use of derivatives for risk management and hedging should be taken into consideration. The IAIS should recognise that systemic risk concerns linked to derivatives have already been addressed by the derivatives reform launched by the G-20 in 2009 and there is therefore no macro-prudential justification for considering the use of derivatives as a source of risk.**

The IAIS assessment is based on the case where, in stressed market conditions, derivatives that need rolling over would become unavailable. While this is a possible scenario, further considerations are needed to appropriately capture the risk of derivatives. Such considerations include: i) the emerging regulatory framework for derivatives ensures, through its design and calibration, that collateral is available to offset losses caused by the default of a derivatives counterparty; ii) if the derivative cannot be rolled over and the insurer has an unhedged balance sheet risk, this should be dealt with by the micro-prudential supervisory framework and not by the systemic risk framework; iii) in many cases derivatives do not need rolling over as the maturity of the derivative matches the expiration of the risk, so the hedge remains in place in all market conditions (unless, of course, default of the counterparty occurs, which should also be part of micro-prudential supervision).

Responses to the questions in the consultation document:

Q1: Based on the above characterisation of NTNI, is the terminology "nontraditional" 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?

Insurance Europe believes that the use of the term "traditional" (in conjunction with "non-traditional") is confusing and it would support an initiative by the IAIS to rename the NTNI. The following observations are worth noting:

- What the IAIS framework could deem as NT may in reality be activities/products in a specific market, which have for a long time addressed policyholders' needs. These activities/products may actually have never caused any threat to financial stability, even during periods of financial market crisis. From this perspective, the term NT appears counter-intuitive.
- Most of the non-traditional versus traditional activities/products broadly present the same fundamental insurance characteristics specific to the insurance business model: insurability through pooling and compensation of losses, inverted production cycle, same accounting regime, regulation and supervision, orderly resolution, matched assets and liabilities, etc.
- It is not because insurance products are complex or innovative (ie non-traditional) that they have potential for systemic risk. As an example, life products that rely on cutting-edge asset/liability management techniques do not pose more threat to the financial system than products managed on a buy-and-hold asset management basis.
- Any new proposal should include a reference to the fact that the activity identified is not necessarily systemic and only potentially systemic.

Q2: Are there any other benefit or liquidity features that should be taken into account in identifying NTNI products and activities?

The list of benefit features is narrow and there is no recognition that a combination of features can in fact create/increase exposure to market/liquidity risk. In addition, the identification framework misses a link between benefit features and liquidity features. Products benefits should be assessed for the social and economic needs they address, as this can significantly impact the liquidity features. Specifically, life benefits are designed to meet the long-term needs of policyholders and to respond to multiple life cycle objectives: saving, retirement, inheritance. This leads to most of the contracts exhibiting very limited liquidity risk.

When assessing product features related to guarantees, a separation should be made between guarantees that apply at any time at the policyholder's discretion and guarantees that apply at maturity or at specific times during product life. In addition to reflecting guarantees as part of the benefit features, the existence of guarantees should be reflected as a separate feature under liquidity risk, as it can create a significant disincentive to surrender, especially in periods of low market returns.

As a general comment, it should be clearly recognised that the callable nature of a product, which may give rise to liquidity risk, does not in itself give rise to systemic risk concerns.

In the area of liquidity features, the ability and extent to which an insurer can adjust surrender payments is an important risk management feature and should be reflected.

Insurance Europe objects to the IAIS approach on derivatives and it believes that the use of derivatives for risk management and hedging should be taken into consideration. The IAIS assessment is based on the case where — in stressed market conditions — derivatives that would need to be rolled over would become unavailable. While this is a possible scenario, further considerations are needed to appropriately capture the risk of derivatives. Such considerations include: i) if the derivative cannot be rolled over and the insurer has an unhedged balance sheet risk, this should be dealt with by the micro-prudential supervisory framework and not by the systemic risk framework; ii) in many cases derivatives do not need rolling over as the maturity of the derivative matches the expiration of the risk, so the hedge remains in place in all market conditions (unless, of course, default of the counterparty occurs).

When derivatives are taken into consideration, the market risk related to the use of derivatives should be identified as being the residual risk not already covered by any existing laws and regulations. Specifically, margining and other risk management requirements that emerged from the G-20 derivatives reform should be appropriately captured in the measurement of risk.

Q3: Do the identified transmission channels appropriately capture the ways in which the vulnerabilities could amplify shocks and create systemic risk? What, if any, other channels should be considered?

There is currently no recognition in the framework that the flow of systemic risk through the transmission channels can be influenced and limited by management and supervisory action.

For the asset liquidation channel, it is important to consider the following:

- Asset liquidation could be triggered by a number of different factors, including idiosyncratic events that affect reputation, extreme market movements and natural catastrophe events. Asset liquidation related to massive withdrawal has never been observed in the insurance sector.
- The presence of guarantees and insurance coverage creates disincentives for policyholders to surrender contracts in stress scenarios, reducing the requirement for insurers to sell assets.
- The presence of guarantees reduces incentives for policyholders to switch to less risky assets in stress scenarios, thereby reducing the requirement for insurers to trade assets.
- Where insurers have the flexibility to allocate assets, the risk of procyclicality should be managed by appropriate mechanisms in micro-prudential regulation.

In addition to assessing the potential transmission channels, it will also be important to assess the capacity to transmit risk to the global financial system. The assessment of systemic consequences of asset liquidation requires more substantial analysis and should, in fact, recognise a number of impacting factors including: size, substitutability, timing in settling policyholders' obligations, trading asset volumes and contingencies in liquidity management.

The interconnectedness measures should relate to NTNI and be assessed as absolute measures so that the materiality of any potential transmission of risk to the global financial system can be assessed in an appropriate context. The high level of substitutability of insurance markets should also be reflected in the measurement of potential for systemic risk flow, as while the insurance sector as a whole is critical to the functioning of the economy, individual companies are not.

Q4: Are these the appropriate two steps that should be used to assess whether a benefit feature could exposure the insurer to substantial market risk? What other steps, if any, should be considered in the analysis? Should the two steps be given equal weighting in the assessment of whether a product has substantial market risk? Should the nature of the two step analysis be disjunctive or conjunctive?

Insurance Europe supports the two-step approach for identifying substantial market risk and notes that the succession of the two steps (as illustrated in the consultation paper) is important, ie question two on ability to invest is only relevant if the answer to question 1, on whether the product exposes the insurer to substantial market risk, is yes.

Insurance Europe agrees with the conclusion in paragraph 3.6 that, where contractual guarantees can be hedged, there is either no correlation of the liabilities associated with the product to the overall market risk or the correlation degree in tail events is not large enough to amplify any existing disruption.

However, Insurance Europe does not support the IAIS approach of assessing market risk based on the ability to match liability cash flows on a buy-and-hold basis and ignoring the use of derivatives.

Derivatives can, in fact, be useful tools for matching risks. Indeed, in a low interest rate environment, the choice of a derivative as a hedging tool over the actual buy-and-hold strategy of an asset could make more sense from an economic perspective.

The consultation paper (footnote 9) notes three elements based on which the IAIS justifies the lack of recognition of derivatives as a mitigating tool. Insurance Europe believes that none of these elements is linked to systemic risk concerns and all of them are, in fact, covered by micro-prudential regulation, so the exclusion of derivatives is not justified:

i. The IAIS assessment is based on the case where, in stressed market conditions, derivatives that need rolling over would become unavailable. While this is a possible scenario, further considerations are needed to appropriately capture the risk of derivatives. Such considerations include: i) if the derivative cannot be rolled over and the insurer has an unhedged balance sheet risk, this should be dealt with by the micro-prudential supervisory framework and not by the systemic risk framework; ii) in many cases derivatives do not need rolling over as the maturity of the derivative matches the expiration of the risk, so the hedge remains in place in all market conditions (unless, of course, default of the counterparty occurs, which should also be part of micro-prudential supervision).

ii. Footnote 9 further notes that the demand for derivatives during a market downturn can cause derivatives prices to rise and become prohibitively high. While this may well be the case, insurers cannot be assumed to be "forced buyers" of derivatives in stressed scenarios. Again, any unhedged risk should be covered by the micro-prudential regulation (which is already the case in Solvency II) and should not be subject to macro-prudential regulation.

iii. Footnote 9 also notes that, in the case of derivatives, market risk is replaced by counterparty risk. While any contractual obligation — including one in the form of a derivative — gives rise to counterparty risk, there is no automatic link to systemic risk. Even more important, addressing derivatives counterparty risk is one of the key outcomes of the G-20 derivatives reform, which was launched in 2009 and triggered a set of measures aimed at increasing the transparency of the derivatives market and addressing systemic risk. There measures included: compulsory central clearing (where possible), compulsory reporting of derivatives and compulsory margining of derivative exposures. Two types of margin were defined: a) the variation margin – aimed at covering daily changes in the market value of a derivative position and b) the initial margin – aimed at covering any changes in the value of variation margin collateral in cases where a default would occur and this collateral would need to be sold. The entire framework for haircuts on collateral and initial margins was very conservatively calibrated with the stated objective of them being sufficient to offset any loss caused by the default of a counterparty with a high degree of confidence. In addition to the important safeguards already embedded in the regulation of the derivatives market, in Europe the prudential framework for insurers (ie Solvency II) includes extra capital requirements meant to cover derivatives counterparty risk. Against this background, Insurance Europe objects to the IAIS consideration of counterparty default risk on the derivatives market.

The IAIS should therefore recognise the value of derivatives in hedging market risk and a more relevant question from the IAIS would be whether derivatives create interconnectedness concerns and of what magnitude these are. Insurance Europe notes that the derivative volumes traded by insurers are marginal compared to those of the banking sector (also largely due to the difference in business models).

Q5: 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?

Insurance Europe believes that the ultimate identification of products and features that can give rise to systemic risk should be left to national supervisors, as they have the knowledge and understanding of their own markets. Insurance Europe supports the objective of a consistent application of the analytical framework across jurisdictions — this should be tested by the IAIS in the process of recalibrating the BCR and the HLA.

As noted in the answer to question 2, the list of benefit features is narrow and there is no recognition that a combination of features can in fact create/increase exposure to market/liquidity risk. In addition, the identification framework misses a link between benefit features and liquidity features. Products benefits should first be assessed in terms of the social and economic needs they address, as this can significantly affect the liquidity features. Specifically, life benefits are designed to meet the long-term needs of policyholders and to respond to multiple life-cycle objectives: saving, retirement, inheritance. This leads to most of the contracts exhibiting very limited liquidity risk.

In addition, the following should be included in the framework:

- Death benefits embedded into a life insurance contract should be explicitly excluded from the scope of the definition of potentially systemically risky activities. Death is an idiosyncratic and insurable risk through the pooling and compensation of losses, which is not related to the business cycle or financial market developments.
- For the fixed-benefit and profit-participation benefit types, the assessment of exposure to market risk should reflect whether the insurer has the ability to generally adjust the surrender value to match market movements, including any guarantees of surrender values. In addition, profit-participation products may or may not be unitised and the guarantee may or may not be tied to the existence of a profit in the first place.

When considering transmission channels, it is important to clearly understand whether insurers expose counterparties to risk or are exposed to risk from counterparties. Given that market risk in itself does not create systemic risk, a lack of clear understanding of the type and direction of counterparty risk can lead to an exaggerated perception of systemic risk created by insurers. Insurance Europe has reservations about whether qualifying guarantees on vested benefits or future accruals expose the insurer to a high degree of market risk as well about the IAIS conclusion that "Product features that have a guaranteed benefit and for which the insurer does not have the ability to invest in assets that will yield sufficient cash flows to pay off expected claims (ignoring derivatives), could expose the insurer to substantial market risk and therefore be classified as NTNI".

The NTNI consultation paper suggests assessing surrender values under normal economic conditions and stressed market conditions. However, the IAIS fails to define the stressed market conditions to establish a robust comparison among the sample firms. This is particularly relevant for the applicability of stays on surrenders, their ultimate duration, and hence the pay-out pattern. While the ability of authorities to suspend surrenders is codified in various markets, it is situational and fraught with rational and behavioural considerations.

Regarding credit guarantees, the table in 3.6 should be amended to clarify that short-term trade credit insurance (coverage period less than one year) is not considered as NT, consistent with the explicit wording of NTNI Principle 1 (annex 2). It is, in fact, inappropriate to include "selling of credit protection/mortgage insurance" in the table set out under paragraph 3.6. Credit protection and mortgage insurance policies do not guarantee the values of assets: they are purchased by individuals to protect payments they are due to make under loan arrangements to which they are parties. Payments are triggered under such a policy by the policyholder's death, disabling injury or illness or loss of job. Credit protection and mortgage insurance should be considered as similar to indemnity policies, since they provide cover for a specific loss, not a guaranteed value.

Q6: Do the proposed time periods appropriately capture liquidity risk?

This question implicitly assumes an acceptance of the level of concern of the IAIS about the risks associated with liquidity. In fact, Insurance Europe believes that the risks are greatly exaggerated in the consultation document. The factors mentioned do to some extent capture liquidity risk, but other considerations need to be taken into account. It would be more appropriate to consider insurers' ability to manage liquidity holistically.

Insurance Europe would expect to see far more numerical analysis of the liquidity risk and of the impact of proposals for a three-month threshold and of other shorter thresholds.

Q7: Other than contractual penalties or taxing requirements, what other economic penalties should be captured? These should be readily quantifiable and generally applicable (i.e. not policy- or policyholder- dependent).

The paper overemphasises exit penalties and fails to consider other factors that are equally important in the assessment of surrender risk. More specifically, the uncertainty that the policyholder faces when evaluating the surrender option is an additional element that should be included in this assessment, as it can translate into a strong disincentive to surrender.

When faced with a surrender decision, policyholders will need to weigh a number of costs and consequences of surrender. These include: whether investment losses may recover over time; whether they are ready to lose valuable benefits/guarantees that are only payable at specified contractual events, such as final bonus payments payable on contract maturity; to be faced with tax implications and specific regimes for inheritance that they had not planned for; to be ready to lose benefits provided under their policy that cannot be replaced; not to be able to secure alternative cover on the same terms with the same product features; to be ready to incur additional costs in securing alternative provisions that would impact their investment; to require advice which may be difficult to find and costly. Such consequences could be reflected in the framework by the inclusion of another type of factor impacting liquidity risk, namely an economic cost or an opportunity cost for the policyholder.

Therefore, given the range of factors and the uncertainty these create, it is not clear why the IAIS is only focusing on exit penalties, as this is just one of many interacting factors and does not represent a good overall proxy.

The loss of qualifying status for tax benefits should also be explicitly reflected in addition to tax penalties.

Insurance Europe would welcome clarification on the reference value for applying the penalty.

Q8: Do the proposed economic penalty thresholds appropriately capture the monetary disincentives to surrender?

See response to question 6.

This question implicitly assumes an acceptance of the level of concern of the IAIS about the risks associated with liquidity. In fact, Insurance Europe believes that the risks are greatly exaggerated in the consultation document. The factors mentioned do to some extent capture liquidity risk, but other considerations need to be taken into account. It would be more appropriate to consider insurers' ability to manage liquidity holistically.

Insurance Europe would expect to see far more numerical analysis of the liquidity risk and of the impact of a proposal for economic penalty thresholds.

Q9: 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?

While the overall approach for assessing liquidity risk requires a better assessment of whether and to what extent product features can give rise to liquidity risk, Insurance Europe believes that the consideration of ancillary factors is very important in order to capture a wider range of factors that can in fact act to mitigate the potential for liquidity risk. The following elements should be reflected in the IAIS approach:

- Guarantees and loss of guarantees should be included as a separate key element of the framework, and not as part of ancillary factors. Guarantees are valuable to policyholders and their perceived value increases strongly in bear markets, which will create a strong disincentive for policyholders to surrender.

- It is not clear how surrender values relative to the market value of assets would be evaluated.
- Supervisors' legal ability to lower surrender values should be considered. In particular, the bottom paragraph of page 19: "In addition, some supervisors are able to reduce the value of guarantees associated with in-force business, which could reduce the pressure on the firm's solvency" should be included in the narrow set of factors or at least in the wider set of factors on page 17.
- The existence of management and/or supervisory actions should be included as a separate factor, as such actions can be used to minimise liquidity risk. More specifically, in many cases insurers have the contractual ability to delay surrenders and/or resolution authorities have the power to apply temporary stays.
- The existence and design of fiscal policies targeting life insurance contracts can significantly change policyholder behaviour and incentives to surrender a product. The loss of qualifying status for tax benefits should be explicitly reflected.
  - The presence of fiscal incentives can make life insurance a very attractive investment compared to other financial products. There is a real fiscal interest for a policyholder to remain invested in its life insurance contract. Loss of tax benefits discourage early surrenders.
  - In addition, the taxation of amounts paid to the beneficiary on the death of the policyholder should be assessed. For example, it should be tested whether such amounts are part of the estate of the beneficiary and whether they support transfer duties on the death of the policyholder.
- It is not clear how the IAIS will evaluate surrender values relative to the market value of assets. This is especially important in the case of products where there is low delay in access (less than 1 week) and no surrender penalties; such products will be deemed to have significant liquidity risk. The presence of guarantees should also be considered as an important factor in making this assessment.
- In cases where insurers decide the asset allocation, there is more flexibility not to liquidate the illiquid assets, thereby exacerbating market movements.

Insurance Europe welcomes the fact that the IAIS has identified in its consultation paper a number of elements that distinguish insurers from banks in terms of liquidity risk. The operational differences between banks and insurers should also be recognised. While bank depositors can access funds immediately through ATMs, bank branches or online banking, insurance policies cannot be surrendered in the same way. In addition, reference to bank deposits runs are made a number of times to explain he liquidity risk — it should however be noted that the banking methodology does not consider the size of retail deposits as an indicator in determining systemic riskiness.

Q10: 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?

Insurance Europe agrees with the statement made in 3.11 that it is "more likely that a complex interaction between contract features, the state of the insurer, the market environment, individual characteristics and other dynamics will determine the extent to which counterparties have an incentive to surrender". Therefore, a framework designed based on only two factors is too simplistic and it is therefore important to consider other elements that can impact liquidity risk, including insurers' ability to manage liquidity risk.

Liquidity risk is managed through proper liquidity management and risk appetite policies, including investments in high quality and liquid assets, adequate derivatives strategies (caps, swaptions) and stress tests.

Liquidity management is often a requirement embedded in the micro-prudential supervisory framework (this is the case for Solvency II). Beyond being a regulatory requirement, the implementation of sound liquidity management policies is an accepted good practice across insurance companies. Where liquidity management is part of a company's risk management approach, the insurer is unlikely to be confronted with immediate liquidity shortfalls.

Portfolio diversification can act as a significant liquidity risk-mitigation tool. Most large insurers have a diversified mix of business that offers a first level of mitigation of the liquidity risk, with a significant part of insurance liabilities being non-callable, notably those related to P&C business and health and protection business. The potential liquidity risk emerging from the savings and retirement business is mitigated by the possibility to mutualise cash resources, at a minimum at the level of a given legal entity, or even within a group of several legal entities.

Insurers can also use financial techniques to mitigate lapse risks and/or their consequences. Especially in the current low interest rate environment, insurers can use swaptions to hedge the risk of a sudden increase in interest rates and its potential consequences. The possibilities that such a strategy offers to insurers can be either to generate additional investment yield if the threshold of the swaption is triggered (and therefore the option of the swaption is exercised) or to sell the swaption, thus offsetting potential losses realised on bonds.

Q11: For those products with both protection and savings components, how should the distinction most clearly be drawn between those that resemble deposits and those that do not? Which considerations should be included in the narrow and the wide sets of ancillary factors?

Products that combine protection and savings components are fairly common in some markets. In principle, one can draw a distinction between term life insurance, which is a protection product, and some unit-linked or participation products which have a protection element, but whose purpose is mainly savings. There is no substitute for analysing the purpose of each product and a crude limit would not be effective.

Q12: 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?

In order to better tailor the framework, Insurance Europe believes that the factors should not be assessed in the case of policies with a purely protection purpose.

Where the contract includes savings and protection benefits that cannot be separated, the contract is very unlikely to be perceived as a pure deposit by a policyholder. In particular, in a systemic crisis the policyholder will cancel other financial contracts first, while keeping the insurance policy as a safe harbour. Therefore, under stressed market conditions, insurance contracts offering mortality or longevity protection provide stability rather than exacerbation. In fact, the protection element of a joint protection/savings product can be a valuable long-term component for the customer. It therefore reduces the liquidity risk to the insurer, as there is a benefit to the policyholder of holding on to the product. For the insurer, the consequence is that the protection element of these policies is a benefit in terms of reducing liquidity risk.

Q13: Recognising that they are not determinative, what other factors might influence insurers' exposure to market or liquidity risk?

A clear distinction needs to be drawn between whether the systemic risk concern relates to the impact of liquidation of assets (if any) on the asset markets or if it relates to losses incurred by insurers where surrender values paid out are more than the value of assets backing liabilities. The latter issue is a micro-prudential regulation issue and will not create systemic risk in itself. In considering the former issue, a broader systemic view needs to be considered:

- In cases where policyholders have a choice of asset allocation, the issue is not insurance-sector specific. The same choices would be made if the investments were made via other intermediaries or directly. In the case of insurers, the presence of cover/guarantees will only reduce incentives to withdraw. Therefore, penalising insurers will not reduce systemic risk.
- In cases where insurers decide the asset allocation, there is more flexibility not to liquidate the illiquid assets, thereby exacerbating market movements. In such cases, insurers could potentially sell more liquid assets to fund any increased surrenders.

- In any case, if there are increased surrenders, the money will move from one part of the financial system to another and it is important that the potential for systemic risk emerging from these surrenders is not exaggerated.

Q14: Should these factors be taken into account as determinative in the NTNI classification? To this end, how might these factors be objectively assessed and weighted, given the differences across jurisdictions and firms? To what extent, if any, do these factors allow for the consistent application of the NTNI concept across jurisdictions?

The factors should not be considered as determinative in the NTNI classification. National supervisors should assess and weight the factors, and comparability should be tested in the recalibration of the BCR and the HLA.

Q15: 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?

Insurance Europe suggests that "Certain types of Property and Casualty/Liability Insurance" is removed from this list. Property and casualty insurance policies are policies of indemnity and do not give policyholders rights to surrenders or other withdrawals. Consequently, they do not give rise to either market or liquidity risk and cannot therefore be classified as NTNI. There would be no benefit in including such products in the analytical review.

Equally, unit-linked products without guarantees should be removed from the list. Based on the IAIS' own analysis and the decision tree illustrated in figure 2, unit-linked products without guarantees pose no market risk. Unit-linked products where policyholders entirely bear the investment risk do not expose the company to liquidity risk if the investments are clearly allocated to the policyholder, no investment guarantees exist or guarantees expire fully in case of surrenders. In cases where policyholders have the choice of asset allocation, the issue is not insurance sector specific and one can argue that the same investment choices would've been made via another intermediary or directly by customers. To the extent that the IAIS wants to analyse unit-linked products without guarantees to inform its understanding of unit-linked products with guarantees it would help if the IAIS made the statement explicitly.

Q16: 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.

A consistent application of the NTNI concept across jurisdictions requires a clear understanding and assessment of the expected impact of failure, the probability of default and the systemic risk potential that is embedded in interconnectedness, liquidity risk and the use of derivatives.

Insurance Europe believes that the NTNI methodology should focus on activities/products that are not socially/economically desirable and/or are not properly managed. For the scope of macro-prudential regulation, supervisors must look at residual risks that are not already captured by existing micro-prudential and other regulation.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of almost €1 170bn, employ over one million people and invest nearly €9 900bn in the economy.