Client Update

IAIS Introduces New Assessment Methodology for G-SIIs and Discontinues NTNI Label

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INTRODUCTION

On June 16, 2016, the International Association of Insurance Supervisors ("IAIS") published its updated assessment methodology for designating global systemically important insurers ("G-SIIs") (the "Revised Methodology").

As part of the review cycle of the IAIS and following consultations in 2015 (see our client update), the Revised Methodology now comprises five phases and adopts absolute reference values for certain indicators.

Additionally, the Revised Methodology incorporates a new approach to the assessment of insurance product features which potentially pose systemic risk, discontinuing the non-traditional, non-insurance ("NTNI") product label. The IAIS acknowledged that use of the NTNI term—an especially important factor in determining whether an insurer is a G-SII and in calculating the capital it will be required to hold—was confusing. While replacing the NTNI product label with a "more granular and nuanced assessment of product features," it maintains the same key features it previously looked at in determining whether an insurer was engaged in particularly risky activities.

In this client update we analyse the Revised Methodology and the end of NTNI in more detail.

G-SIIS

G-SIIs are designated by the international Financial Stability Board ("FSB") on the IAIS's recommendation and are classified as those insurers whose distress or disorderly failure would cause significant disruption to the global financial system and economic activity because of their size, complexity and interconnectedness.

Nine firms were designated as G-SIIs in November 2015: Aegon, Allianz, AIG, Aviva, AXA, MetLife, Ping An, Prudential Financial and Prudential plc. As a result of their G-SII status, these firms are subject to heightened prudential requirements, including the holding of additional capital.

The G-SII designation—and the factors used by the IAIS in assessing whether an insurer should be identified as one—are distinct from similar labels imposed at the national level. The distinction between the FSB's global designations and their impact at a national level was highlighted by MetLife's recent success in overturning its designation as a non-bank systemically important financial institution by the US Financial Stability Oversight Council ("FSOC").[1] China has also announced its intention to designate a group of "Chinese G-SIIs" on which it will impose special requirements.

Although the IAIS seeks in the Revised Methodology to improve the transparency of the G-SII designation process, significant uncertainties remain for large global insurers as to which firms will be designated as G-SIIs. Such firms will now face increased pressure to avoid the risk of any unintended consequences when making strategic decisions.

THE REVISED METHODOLOGY

IAIS's initial assessment methodology was first published in 2013. The arrival of the Revised Methodology comes now as part of the three-year review cycle of the IAIS.

Broadly, the Revised Methodology is closely aligned with the draft produced as part of the consultation in November 2015, with the most significant change being the removal of the NTNI label (see below).

The three phases of the initial assessment methodology have been expanded to five phases in the Revised Methodology:

- Phase I: data collection;
- Phase II: quality control and scoring, then determination of a quantitative threshold;

[1] The FSOC filed its arguments to appeal the ruling of the U.S. District Court for the District of Columbia on June 16, 2016. Both sides have indicated that the case could reach the U.S. Supreme Court.

- Phase III: discovery, where further quantitative or qualitative information is collected and analyzed;
- Phase IV: exchange with prospective G-SIIs, who may present additional information; and
- Phase V: recommendation to the FSB.

As in the consultation paper, Phases I and II incorporate the quantitative components of the Revised Methodology, with Phases III and IV comprising both quantitative and qualitative elements.

The indicators and weights measured as part of Phase II, which include, for example, revenues derived outside of home country, utilization of reinsurance and liability liquidity, have been reorganized as a result of the removal of the NTNI category. The indicators themselves remain almost unchanged in the Revised Methodology, with certain weightings shifting a percentage point in either direction.

The key change is that the Revised Methodology uses absolute reference values for three indicators, namely reinsurance, derivatives trading and financing guarantees. The outcome of this new approach is that the indicators are no longer calculated solely as the relative importance of an insurer as against other insurers. The absolute values demonstrate changes in the systemic risk of the insurer over time, for instance where an underlying market undergoes change. This responds to a key criticism from insurers, who argued that the prior approach of comparing an insurer against others in determining the indicator weighting penalized those insurers which had relatively high use of the particular indicator—such as use of reinsurance—when the overall risk was still relatively low.

GOODBYE NTNI

Also published on June 16 was the IAIS's paper on insurance product features that increase the potential to pose systemic risk (the "Paper"). The most significant change to the framework set out in the Paper is the discontinuation of the NTNI product label.

Replacing the NTNI concept is "a more granular and nuanced assessment of product features." The new approach outlined in the Paper follows feedback from industry during last year's consultation that demonstrated confusion around the term "non-traditional" and a lack of clarity around NTNI activities and products. In particular, the IAIS stressed that the intention was not to provide for a "binary classification" of insurance products, but rather a more detailed approach that looked at the risk of the products and the likelihood that any disruption could be transmitted to other financial market participants, causing systemic risk.

Under the new approach, the IAIS will analyze products by the "macroeconomic exposure" and "substantial liquidity risk" that they create, and the risk of transmission to others causing systemic risk (such as "run on the bank" scenarios). The Paper clarifies what is meant by substantial liquidity risk and macroeconomic exposure, though the IAIS stresses that the metrics for macroeconomic exposure will be refined through ongoing review. The list of product features, and therefore products, that expose an insurer to substantial risk remains unchanged from 2013, however, although they have been reorganized to account for the new framework.

Additionally, the Paper recognizes other activities that may be undertaken by an insurer outside of insurance. Capital market activities equating to "shadow banking," including investment and funding resulting in maturity or liquidity transformation, leverage or imperfect transfer of credit risk, such as repo and securities lending, "should be considered potentially systemic non-insurance activities" and, like before, will be taken into account in determining whether an insurer is a G-SII and the amount of capital it must hold.

INDUSTRY COMMENT

The key message from the attendees of the IAIS Global Seminar in Budapest on June 16 and 17, 2016 is that this is an important time in global financial regulatory evolution which will be shaped by ongoing and increasing dialogue between existing G-SIIs and global financial markets participants more generally.

CONCLUSION

The potential impact of IAIS's amended methodology for the designation of G-SIIs remains unknown at this stage; any changes to the list of designated G-SIIs will be revealed only later this year at the end of the current review cycle. A further question that remains open is whether the IAIS will take any steps to address the apparent gap in its approach in respect of the treatment of reinsurers.

Regardless of the ultimate impact, the amendments themselves evidence in some respects continued trends towards convergence between international and U.S. standards for the designation and regulation of systemically important insurance groups, particularly with respect to multi-stage designation processes and an emphasis on liquidity and market risk as drivers of potential systemic importance. The recently commenced formal Federal Reserve Board rulemaking process for establishing capital and supervisory standards for insurers under its jurisdiction will provide additional data as to these trends and the interaction between the two processes.[2]

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Please do not hesitate to contact us with any questions.

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[2] See Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610 (June 14, 2016); Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (June 14, 2016).