FS Regulatory Brief

G-SIIs vs. G-SIFIs: Lines blur between insurance and banking

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As a part of a global initiative to help prevent a repeat of the 2008 financial crisis and reduce the threat posed by global systemically important financial institutions (G-SIFIs), the International Association of Insurance Supervisors (IAIS) has released its proposed assessment methodology for the identification of global systemically important insurers (G-SIIs). Under the purview of the Financial Stability Board (FSB) and the G20, the IAIS has been charged with the task of recommending which insurance companies should be deemed G-SIIs and ultimately designated as such by the members of the G20.

In its assessment methodology, the IAIS devotes discussion toward the deference shown to the jurisdictional regulator and the need to share information amongst regulatory agencies. Furthermore, the proposed criteria attempts to identify any insurers whose distress or disorderly failure—due to their size, complexity, and interconnectedness—would cause significant disruption to the global financial system and economic activity. Unlike the Financial Stability Oversight Council's (FSOC's) recently published proposed rule for designating US non-bank financial companies as SIFIs, the IAIS brought to light how the traditional insurance business model has several unique features which are not typically found in banking, and which therefore make the insurance industry less risky than banking, in their view. It is worth noting that in the US, the FSOC made no such delineation for specific industries in establishing the systemic risk criteria.

Background and timing

During the global financial crisis, a host of financial institutions, including certain non-bank financial institutions, both contributed to and were impacted by the accompanying severe economic distress. These non-bank financial companies were not subject to the type of prudential regulation and supervision applied to banking organizations.

In response, at a November 2010 summit meeting in Seoul, the G20 leaders endorsed a report by the FSB on reducing the "moral hazard posed by systemically important financial institutions." Initially, the global supervisory community focused primarily on the banking sector, as evidenced by the Basel Committee on Banking Supervision's developed framework for identifying global systemically important banks (G-SIBs) and the FSB's list of 29 G-SIBs, both of which were published during November 2011. In conjunction with the G-SIB identifications, the G20 reiterated the expectation that the IAIS would complete its assessment methodology for identifying G-SIIs in time for the G20 summit in June 2012.

During 2011, the IAIS commissioned a data call where insurers were asked to submit data confidentially for review. It was revealed over the course of that data review that there was a need to establish common metrics and trigger criteria. After several months of deliberations to develop its criteria, the IAIS's rule was proposed on May 31, 2012, for a 60-day comment period (which will end on July 31, 2012). Once the criteria is set, a second data call will be issued, probably during 4Q 2012, with G-SII determinations and recommendations expected to occur during early 2013.

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Financial stability considerations: insurance vs. banking

Numerous insurance industry experts have noted that while banks floundered during the financial crisis, the insurance industry, overall, performed well (with the exception of certain firms that were involved in banking-related activities). As such, it is expected that when determining G-SII status, the majority of the analysis will be based on firms' non-traditional insurance activities, as articulated in the proposed rule.

In the IAIS's assessment methodology, particular distinction was made between the traditional insurance business model and the banking business model, which typically involves payment systems, deposit gathering, credit intermediation, or investment banking services. In contrast, unique features identified by the IAIS for traditional insurance businesses include the technique of pooling insurance risk, a liability-driven investment approach, cash outflows that occur over an extended period of time, and a high degree of substitutability.

The insurance business model is based upon the assumption of a large number of ideally uncorrelated risks from policyholders to establish and maintain a well-diversified portfolio. As articulated in the rule, insurance is founded on the law of large numbers, which states that the aggregation of a large number of idiosyncratic risks ultimately results in a normal curve of distribution. As such, there is less opportunity for unexpected results and a lower probability of large losses, in relation to the entire portfolio. Unlike banks, the risk profile of an insurer actually becomes less risky as more risks are assumed. The potential for systemic risk within the insurance sector therefore needs to be considered when insurers deviate from the traditional insurance business model and enter into non-traditional insurance or non-insurance activities. Accordingly, in determining an insurer's relative score, the IAIS has proposed significantly higher weights for non-traditional and non-insurance activities and interconnectedness categories.

Methodology

Utilizing year-end 2010 non-public data collected in 2011 through national supervisors from 48 select insurers in 13 jurisdictions, the IAIS developed proposed criteria whose analysis includes both quantitative and qualitative components. Similar to the Basel Committee's approach to identifying G-SIBs, the IAIS approach attempts to measure global systemic importance by focusing more on the impact that an insurer's distress or failure would cause, rather than the probability of such a failure.

In addition to a few financial guarantors, the 48 insurers were selected utilizing the following criteria:

- Total assets of US$60 billion or more, with a ratio of premiums from jurisdictions outside the home jurisdiction to total premiums equaling 5% or more
- Total assets of US$200 billion or more, with a ratio of premiums from jurisdictions outside the home jurisdiction to total premiums equaling between 0% and 5%

The assessment methodology is based on three steps: the collection of data, an indicator-based assessment of the data, and a process of supervisory judgment and validation based on an 18-point system. The 18-point system is divided into five categories covering size, global activity, interconnectedness, substitutability, and non-traditional and non-insurance activities. The identified indicators attempt to capture the degree and nature of each insurer's systemic importance from multiple dimensions. These indicators are enumerated in the following table.

Category	Category weighting (%)	Individual indicator	Indicator weighting (%)
Size	5–10	• Total assets • Total revenues	2.5–5
Global activity	5–10	• Revenues derived outside of home country • Number of countries	2.5–5
Interconnected ness	30–40	• Intra-financial assets • Intra-financial liabilities • Reinsurance • Derivatives • Large exposures • Turnover • Level 3 assets	4.3–5.7
Non-traditional and non-insurance activities	40–50	• Non-policyholder liabilities and non-insurance revenues • Derivatives trading • Short-term funding • Financial guarantees • Viable annuities • Intra-group commitments	6.7–8.3
Substitutability	5–10	• Premiums for specific business lines	5–10

Implications of identification

While the practical implications of G-SII designation have yet to be finalized, the proposed assessment methodology provides possible ramifications for designated G-SII insurers, which generally follow the FSB's framework. Policy measures that could be applied include:

- Enhanced supervision
- Removal of barriers to orderly resolution
- Higher loss absorbency levels
- Other supplementary prudential measures as determined by national authorities

Given the focus of the methodology on non-traditional and non-insurance activities and interconnectedness as the most likely source of systemic risks, greater policy measures are also anticipated to address these activities.

IAIS vs. FSOC

The IAIS claims to be consistent with the FSOC. However, there are distinct differences in the two rules, most notably in the treatment of non-traditional non-insurance activities, which have the largest weighting factors in the IAIS rule. If the US is desirous of a coordinated global approach, the FSOC may wait until after the IAIS has made its company designations to the G20 prior to naming any US insurers as SIFIs.

The IAIS criteria and proposed weighting factors to those criteria are distinct from those of the FSOC, advocating that size alone should not be a determining factor. In fact, the IAIS opines that size in traditionally regulated insurance is actually a favorable characteristic since "in an insurance context size is a prerequisite for effective pooling and diversification of risks." Consequently, the IAIS assigns only a 5% to 10% weighting factor to size criteria, while assigning the most significant weight to non-traditional and non-insurance activities (40%–50%) and interconnectedness (30%–40%). Unlike the FSOC approach, the IAIS methodology adds the criteria of international activity and type of activities in which an insurer engages, recognizing the unique features of insurance, such as the long horizon of insurance liabilities, the concept of pooling of risks, insurable interest, and cash claims patterns.

Future steps

The first cohorts of G-SIIs are expected to be designated during the first half of 2013, subject to the finalized assessment methodology and supervisory validation process. Going forward from 2013, it is anticipated that the IAIS will continue to collect relevant data and publish a list of G-SIIs in November of each year. As such, given the timing, recovery and resolution plans for designated insurers would need to be in place by mid-2014. Since insurers can migrate in and out of G-SII status over time, the IAIS does not intend to develop a static list of G-SIIs, which provides incentive to insurers to adjust their risk profile and reduce their systemic importance where applicable.

Additional information

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