THE ROLE OF MACROPRUDENTIAL POLICY IN THE INSURANCE SECTOR: EXPERIENCE DURING THE COVID-19 CRISIS

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NB: The views expressed in this article are those of the Secretary General of the IAIS and do not necessarily reflect those of the IAIS or its members.

The International Association of Insurance Supervisors (IAIS) has evolved its approach to assessing and mitigating systemic risk in the global insurance sector. This new approach is termed a "Holistic Framework", recognising that systemic risk may not only arise from the distress or disorderly failure of individual insurers but also from the collective exposures of insurers at a sector-wide level.

This article sets out this new approach, which consists of three reinforcing pillars: (i) macroprudential monitoring at a global level; (ii) the application of more stringent supervisory requirements to a broader portion of the insurance sector; and (iii) assessing the consistent implementation of those standards.

During the Covid-19 pandemic, the Holistic Framework has already proven its value as it has allowed the IAIS to monitor the impact of Covid-19 on the global insurance sector through targeted data collections and has provided the necessary toolkit for insurance supervisors to take a coordinated approach to systemic events.

The mission of the International Association of Insurance Supervisors (IAIS) is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability. The IAIS activities supporting this mission can be described as follows *(see Diagram 1)*.

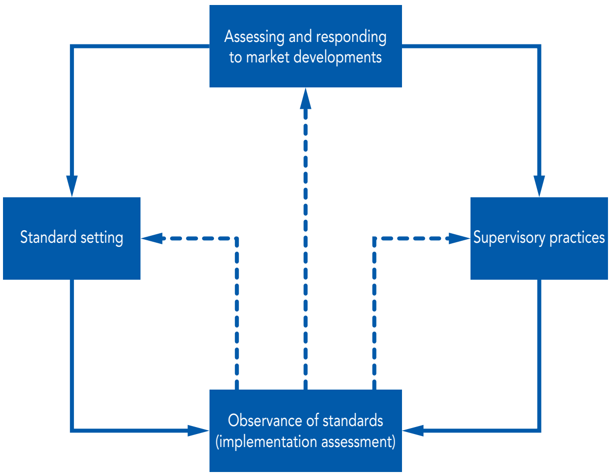
- Assessing and responding to market developments:
  Monitoring global market trends and developments, including macroprudential monitoring (i.e. the global monitoring exercise – GME – of potential systemic risk in the insurance sector).

- Standard setting:
  Setting and maintaining globally recognised standards for insurance supervision that are effective and proportionate.

- Supervisory practices:
  Supporting supervisors to put supervisory material into practice, e.g. by developing supervisory guidance papers and peer exchange platforms.

- Observance of standards:
  Assessing implementation of IAIS supervisory material as well as facilitating supervisory capacity building.

Diagram 1 IAIS activities



Source: International Association of Insurance Supervisors (IAIS).

1 Holistic Framework

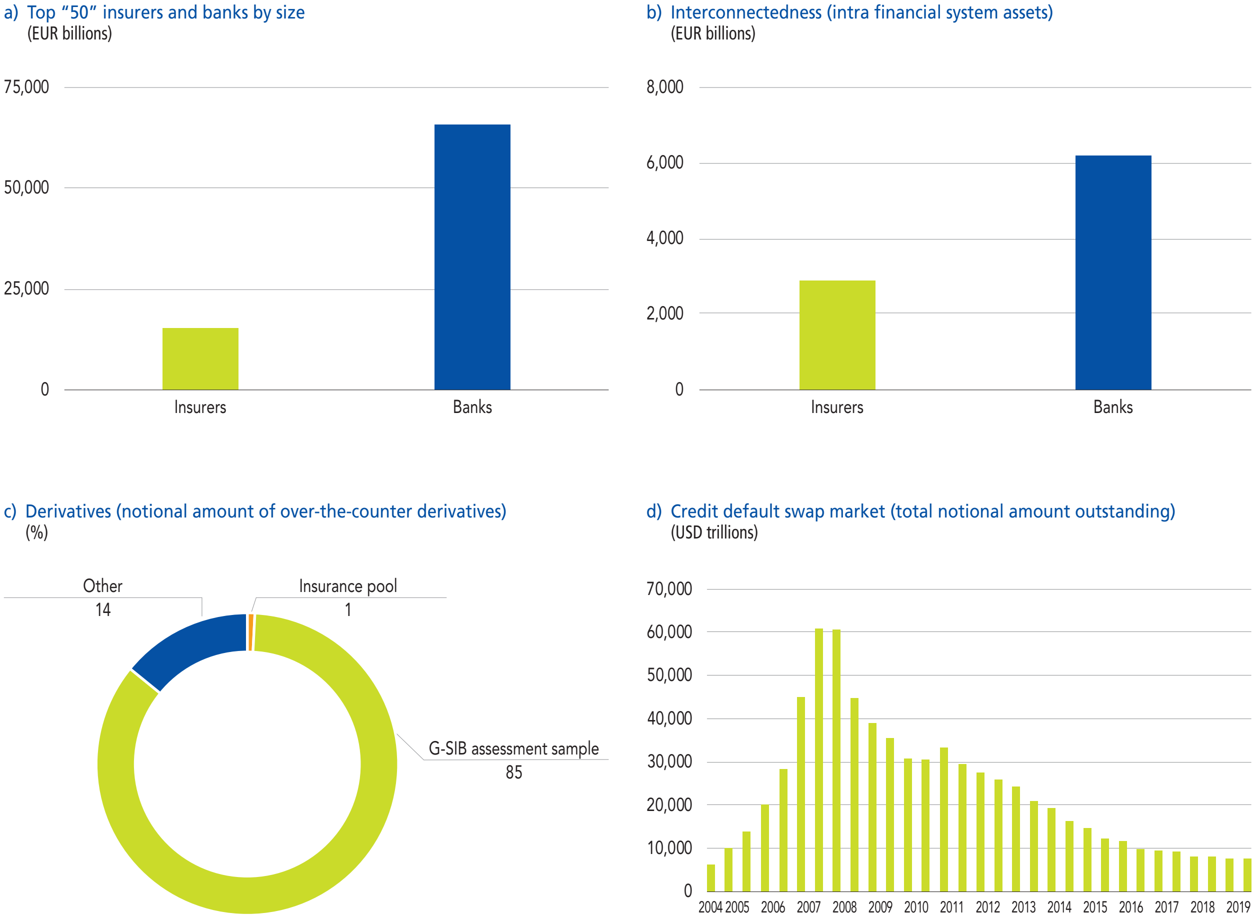
Consistent with this reinforcing cycle of IAIS activities, the Holistic Framework for the assessment and mitigation of systemic risk in the global insurance sector ("Holistic Framework")[1], adopted in November 2019, consists of the following key pillars:

- macroprudential monitoring at a global level (the GME);[2]
- supervisory and supporting material, including more stringent requirements to a broader portion of the insurance sector;[3] and
- assessing consistent implementation of IAIS standards.

In doing so, the IAIS takes a holistic approach at various levels. Firstly, it recognises that systemic risk in the insurance sector may arise not only from the distress or disorderly failure of an individual insurer but also from the collective exposures and activities of insurers at a sector-wide level. Secondly, since insurers form an integral component of the financial system, the Holistic Framework contributes to a cross-sectoral view when assessing systemic risk. In the development phase of the framework, the IAIS and the Financial Stability Board (FSB) collaborated closely and the framework also benefited from cross-sectoral work undertaken in conjunction with the Basel Committee on Banking Supervision (BCBS). Thirdly, the Holistic Framework takes into account the time-varying nature of systemic risk, e.g. the state of the overall economy or the stability of certain financial markets.

Chart 1 provides four illustrations of the relevance of taking a holistic perspective. While insurers play a crucial role within the global financial system, the scale and interconnectedness of insurers compared to banks is quite limited, as illustrated by the total balance sheet size and total financial system assets of the top 50 insurers worldwide relative to that of the top 50 banks (by size). Hence, the issue of "too big to fail", or "too interconnected to fail", at an individual insurer level is limited compared to that of individual banks. Similarly, in the global over-the-counter (OTC) derivatives market, the share of the approximately largest 50 insurers worldwide is less than 1%. Finally, the relevance of taking a time-varying view can be illustrated by looking at the development over time of the derivatives trading market (credit default swaps – CDSs); a market that played a crucial role in the great financial crisis. At its peak in 2007, insurance group American International Group's (AIG) notional portfolio of CDS commitments amounted to USD 530 billion.[4] By end-2019 the total CDS market shrank by more than 85%. To summarise, taking a holistic view supports a systemic risk assessment that is proportionate

C1 Insurers within the broader financial system



Sources: International Association of Insurance Supervisors (2019d), Basel Committee on Banking Supervision (2019), Bank for International Settlements (2019).
Notes: All data per year end 2018, except for the data on credit default swap market which is from year end 2019.
The top 50 insurers is based on 2019 global systemically important insurer (G-SII) data collection exercise in which around 50 insurers participated ("Insurance Pool").
The top 50 banks is based on the top 50 banks (ranked by size) participating in the global systemically important banks (G-SIB) exercise.
The G-SIB Assessment Sample consists of all 75 banks participating in the G-SIB exercise.

to the actual risk, and takes into consideration that the systemic impact of the insurance sector may also depend on the functioning of other elements within the wider financial system.

This holistic approach is consistent with that of other standard setting bodies (SSBs), that have also carefully considered the appropriate balance between a focus on individual entities and a focus on sectoral or activities.[5] For the banking sector, this has resulted in a combination of additional requirements for global systemically important banks (G-SIBs) and the integration of various macroprudential tools into the sector-wide Basel III Framework, such as a leverage ratio, liquidity requirements or the countercyclical buffer. For the asset management sector, this consideration has instead resulted in a principal focus on activities, aimed at addressing structural vulnerabilities from asset management activities. Any further work by the FSB and International Organization of Securities Commissions (IOSCO), in the case of asset management, will be on any residual entity-based sources of systemic risk from distress or disorderly failure that cannot be effectively addressed by market-wide activities-based policies.[6]

1 See IAIS (2019a).
2 See IAIS (2019b).
3 See IAIS (2019c).
4 See AIG (2007).
5 See Saporta (2016).
6 See FSB (2017).

2 Global Monitoring Exercise (GME)

The first step in any macroprudential policy framework is the monitoring and assessment of risks and developments that may ultimately affect financial stability. The IAIS is undertaking this monitoring exercise at the global level. The IAIS' GME involves an annual data collection (plus additional deeper dive data collections as need be) of insurance market trends and developments to determine any potential build-up of systemic risk in the global insurance sector. The IAIS' GME serves as a complement to the macroprudential surveillance at the jurisdictional or regional level by supervisors aimed at monitoring systemic risks building up within jurisdictions *(see next section)*. This enables a feedback loop between the global monitoring by the IAIS and the macroprudential surveillance by supervisors. For instance, vulnerabilities building up in certain jurisdictions may have cross-jurisdictional implications. Correspondingly, the interpretation of global trends will benefit from having a better understanding of the underlying trends at the jurisdictional or regional level.

The GME takes a holistic approach by collecting data at both the individual insurer level and at an aggregate, jurisdictional level: it covers quantitative information from around 50 of the largest international insurers as well as from IAIS member jurisdictions that account for about 90% of the global market (in gross written premiums, 2019). This is complemented by a qualitative survey that covers supervisors' assessments of macroprudential risks, in terms of probability, impact and trends, and supervisory responses, as applicable. Potential sources of systemic risk that are analysed include counterparty exposures, macroeconomic exposure and liquidity risk.

Under the Holistic Framework, data collection is no longer focussed on identifying prospective Global Systemically Important Insurers (G-SIIs), but rather aims to support a comprehensive and forward-looking assessment of the potential build-up of systemic risk in the insurance sector. The data analysis and qualitative input from supervisors, together with engagements with key stakeholders such as Chief Risk Officers (CROs) of the global insurance groups, will be used to inform an annual collective discussion amongst IAIS members on the potential global systemic risk in the insurance sector and a coordinated supervisory response, if necessary. The discussion of appropriate supervisory responses will include the consideration of enhanced supervisory policy measures and/or powers of intervention, taking into account the IAIS' assessment of those supervisory policy measures and/or powers of intervention that have already been implemented.

The IAIS will share the outcomes of the GME each year with participants in the GME (participating insurers and IAIS members), the FSB and the general public.

Key success factors and challenges

Data gaps

The GME relies on the quality, completeness and timely submission of the requested data as well as on the use of appropriate analytical tools to assess the data. While the IAIS has been collecting and analysing data on an individual insurer level since 2013 (as part of the G-SII data collection exercise), the data collection at a sector-wide jurisdictional level is a newer development. An important component of the GME is the assessment of interplays between these two complementary data collections, recognising the challenge that while both data collections target the same risks, they take a different perspective and consolidation approach (group-level versus legal-entity level).

Responding to emerging risks

As part of the GME, and in line with its strategic plan,[7] the IAIS will also explore emerging and accelerating risks such as climate change and cyber risks. These trends deserve further investigation to assess their potential impact on insurance markets and the wider financial system and real economy, in terms of opportunities, challenges and risks. Under the GME, such further analysis can be undertaken via ad-hoc deep dive data collections and qualitative assessments.

The first deep dive is on the potential financial stability impact of climate change on the insurance sector, which will be focussed on insurers' investment exposures to climate-related risks. The analysis is supported by an ad-hoc data collection amongst IAIS members, aimed at gathering information on relevant exposures on insurers' balance sheets as well as on supervisory risk assessments. The results of the analysis are due to be published in mid-2021.

Forward-looking collective discussion

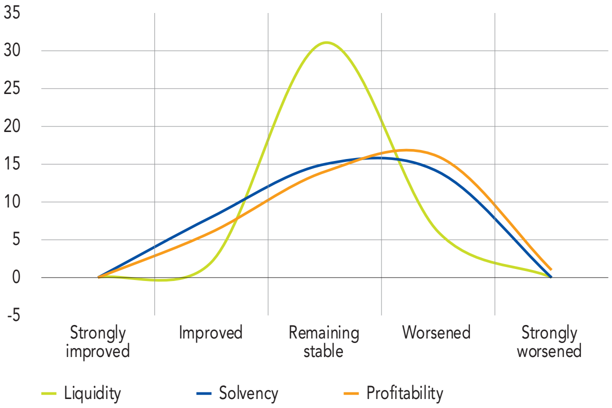
The collective discussion at the IAIS level of the results of the quantitative data collection and qualitative input from supervisors is a crucial element of the GME as it is the basis for a globally-coordinated response to the potential build-up of systemic risk. This global coordination is a complement to macroprudential supervision at the jurisdictional or regional level.

In order to ensure a forward-looking and comprehensive discussion, the IAIS has agreed on quantitative criteria to assist the annual determination of the focus of the collective discussion. These include trend and outlier criteria to indicate the build-up of potential systemic risks. The use of quantitative criteria is complemented by expert judgement, acknowledging that relevant developments may be overlooked when only using a defined set of quantitative criteria, given the dynamic nature of systemic risk. Finally, the IAIS identified a level criterion to provide an indication of a situation in which potentially systemic activities or exposures become concentrated in an individual insurer, such that its distress or disorderly failure would pose an actual and serious threat to global financial stability.

Assessing the impact of Covid-19

Utilising the GME framework, the IAIS was able to quickly adapt and repurposed the GME to assess the impact of Covid-19 on the global insurance sector's solvency, profitability, liquidity, assets and liabilities. Both individual insurers and supervisors participated in the exercise by providing data and qualitative information on the risk assessment (*see Chart 2*) and forward-looking outlook.

C2 Qualitative supervisory assessment of the impact of Covid-19, Q2 2020
(number of respondents)



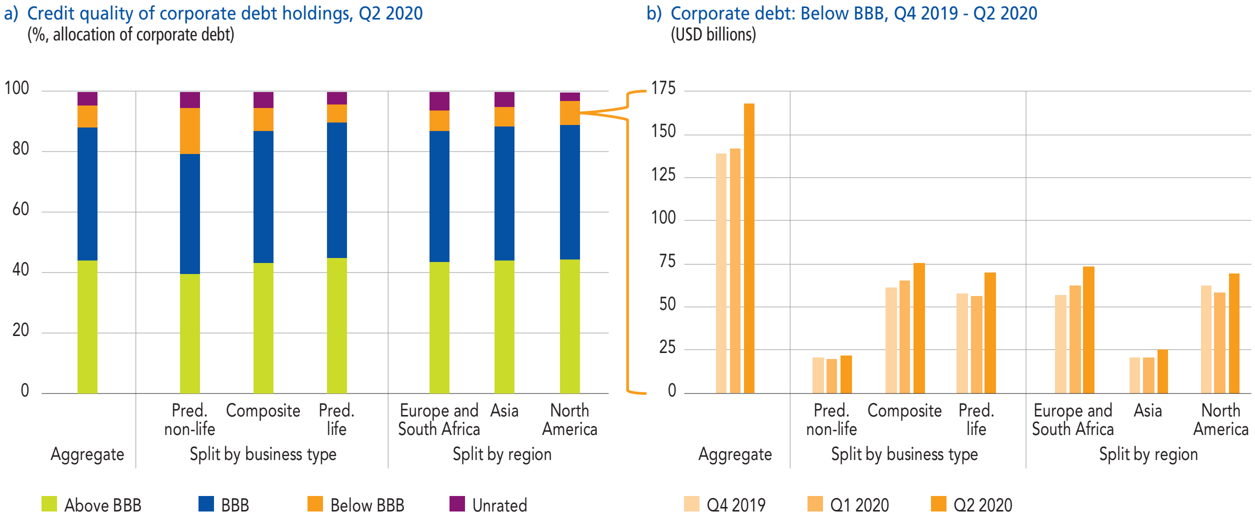
Source: International Association of Insurance Supervisors (2020a).

High-level results indicate that although the financial market volatility caused by the Covid-19 crisis in the first half of 2020 did affect the global insurance sector's solvency and profitability (primarily through its impact on assets), insurers' available capital resources generally remained well above requirements. Following a significant initial shock to the financial market, the global insurance sector has demonstrated both operational and financial resilience, aided by supervisory measures providing operational relief and by monetary and fiscal support measures in financial markets in certain regions. However, vulnerabilities remain, given the uncertainty about the duration and ongoing impact of the Covid-19 crisis. These vulnerabilities include the potential for the credit quality of insurers' fixed-income portfolios (*see Chart 3*) to decrease and the impact of the deepened low-yield environment. Overall, the vast majority of insurers' portfolios of corporate and sovereign bonds are investment grade. However, some insurers have experienced rating downgrades in their corporate bond portfolios.[8]

7 See IAIS (2019e).

8 See IAIS (2020a).

C3 Corporate debt holdings (composition by rating; change in non-investment grade exposure)



Source: International Association of Insurance Supervisors (2020a).
Note: Pred. life = insurance groups predominantly active in life insurance business; similar for "pred. non-life".

3 Supervisory and supporting material

The IAIS supervisory material, consisting of the Insurance Core Principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs; "ComFrame"), aims to protect policyholders and to contribute to global financial stability through the maintenance of consistently high supervisory standards in IAIS Member jurisdictions. The ICPs apply to insurance supervision of all insurers, whereas ComFrame applies to IAIGs only.

In developing the Holistic Framework, the IAIS adopted revisions to the ICPs and ComFrame by enhancing or adding supervisory policy measures specifically designed to assess and mitigate potential systemic risk building up in the insurance sector. The policy measures are deliberately not labelled as either microprudential or macroprudential measures. By mitigating certain risk exposures, policy measures that primarily have a microprudential perspective may also help increase the resilience of the insurance sector as a whole and/or decrease the probability and magnitude of any negative systemic impact. Likewise, many measures that are primarily aimed at macroprudential analysis, such as supervisory sector-wide stress testing, are also microprudential tools.

With this, the IAIS has moved away from the previous binary approach, in which certain pre-determined policy measures applied only to a small set of identified G-SIIs. Instead, it promotes a proportionate application of supervisory material for macroprudential purposes to a broader portion of the insurance sector.

The supervisory material includes:

- ongoing supervisory requirements applied to insurers, targeted at key potential systemic exposures: liquidity risk, macroeconomic exposure and counterparty exposure;
- macroprudential supervision, aimed at identifying vulnerabilities and addressing the build-up of systemic risk at the individual insurer and sector-wide levels; and
- crisis management and planning, which includes requirements on recovery and resolution planning, as well as the establishment of crisis management groups.

In terms of powers of intervention, supervisors are required to have a sufficiently broad set of preventive and corrective measures in place to enable a prompt and appropriate response when a potential systemic risk is detected.

T1 Overview of supervisory policy measures

Thematic area	High-level description	Scope of application		G-SII policy measures
		Legal entity/group	IAIG	
Macroprudential supervision	Enhance the link of macroprudential supervision to supervisory review and reporting	●	●	
	Requirements on macroprudential supervision	●	●	
Requirements on insurers	Enterprise risk management requirements related to: • liquidity risk, • counterparty exposures, and • macroeconomic exposure.	●	●	● (liquidity management and planning only)
	Public disclosure requirement for liquidity risk	●	●	
Crisis management and planning	Coordination of crisis management preparations	●	●	
	including the establishment of crisis management groups		●	●
	Requirement on recovery planning	●	●	●
	Resolution framework including resolution powers	●	●	●
	Requirement on resolution planning		●	●
Powers of intervention	Preventive and corrective measures	●	●	● (systemic risk management plan)

[ ] Not applicable.
[•] Applicable/required.
[•] Applicable/required as necessary only.
[•] Comparable G-SII policy measure.
Source: International Association of Insurance Supervisors (2019a).
Note: IAIG – Internationally Active Insurance Group, G-SII – Global Systemically Important Insurer.

A full overview of the policy measures is depicted in Table 1, showing also how the Holistic Framework supervisory policy measures have a wider scope than the G-SII policy measures, both in terms of scope of application and range of the measures.

Practical application of supervisory measures during Covid-19

Many of these policy measures are being implemented in practice during the Covid-19 crisis. The IAIS has facilitated the sharing of information and discussion amongst its membership on supervisory responses to the impact of Covid-19. To this end, the IAIS developed a repository of regulatory, supervisory, financial and other policy measures being taken or planned by IAIS members in response to Covid-19. In response to identified vulnerabilities, insurance supervisors have taken a variety of measures. These include measures related to the Holistic Framework, such as:

- enhanced supervisory reporting on solvency, liquidity and profitability;
- scenario analysis and stress testing, while also requesting updates of insurers' own risk and solvency assessments (ORSA); and
- measures to limit or delay dividend payments and variable remuneration.

Supporting material

As referenced in the introduction, one of the key IAIS activities is supporting supervisors to put supervisory material into practice, for instance by developing application papers. These provide further advice, illustrations, recommendations or examples of good practice to supervisors on how supervisory material may be implemented. Related to the Holistic Framework, the following application papers are worth mentioning.

- Liquidity risk management
  This paper provides guidance and examples of considerations in applying liquidity risk management measures and on integrating this into an insurer's enterprise risk management. This notably relates to requirements around liquidity stress testing; maintenance of a portfolio of unencumbered highly-liquid assets; a contingency funding plan; and the submission of a liquidity risk management report to the supervisor. The paper was published in June 2020.[9]
- Macroprudential supervision
  The objective is to provide support to supervisors for the implementation of ICP 24 (macroprudential supervision), in designing processes and procedures for macroprudential supervision, including monitoring and analysis activities. The paper will also provide examples on the use of macroprudential surveillance tools, including supervisory stress testing. The draft Paper is planned to be published for consultation in March 2021.
- Resolution powers and planning
  The objective is to provide support to supervisors in setting up a resolution framework for insurers, including the resolution powers, resolution planning and management information systems. It also discusses good practice on (cross-border) crisis management and planning with other involved supervisors. The draft paper was published for consultation in November 2020 and is planned to be finalised by mid-2021.[10]

4 Implementation assessment

The assessment of consistent implementation of the supervisory material is the final key element of the Holistic Framework. Credible and independent assessment of implementation of the IAIS supervisory material is critically important to supporting effective and globally consistent supervision, thereby contributing to financial stability. Increasing the transparency around implementation gaps and challenges is equally important in supporting observance of the supervisory material.

In line with the IAIS Assessment Methodology for ICPs and ComFrame, the Holistic Framework implementation assessment determines whether the supervisor has and exercises, when required, the legal authority and supervisory practices to effectively perform and enforce the requirements of the relevant Holistic Framework supervisory material.

The implementation assessment of the Holistic Framework proceeds in phases, beginning with a baseline assessment in 2020 and moving to more intensive jurisdictional assessments from 2021. The baseline assessment aims to determine the extent to which supervisors have implemented the Holistic Framework supervisory material

9 See IAIS (2020b).

10 See IAIS (2020c).

and relies for a large part on jurisdictional self-assessments. The second phase will consist of more intensive targeted jurisdictional assessments, which will include in-depth verification of supervisory practices.

As part of the baseline assessment, and acknowledging that the framework was adopted just last year, IAIS Member jurisdictions were also asked to report on their implementation progress and to share their implementation plans where there are gaps. A total of 25 jurisdictions participated in the assessment, covering over 90% of the global insurance market and representing a geographically-balanced sample. A public report will be issued in March 2021.

Conclusion

The Holistic Framework, appropriately implemented, provides an enhanced basis for mitigating systemic risk in the insurance sector. In November 2019, the FSB welcomed the finalisation of the IAIS Holistic Framework.[11] In light of the finalised Holistic Framework, the FSB, in consultation with the IAIS and national authorities, decided to suspend G-SII identification as from the beginning of 2020. In November 2022, the FSB will, based on the initial years of implementation of the Holistic Framework, review the need to either discontinue or re-establish an annual identification of G-SIIs by the FSB in consultation with the IAIS and national authorities.

Reflecting upon the first year of implementation, which has unfolded very differently than anticipated, the Holistic Framework has already proven its value and versatility. The IAIS had to rapidly adjust its activities in light of the pandemic, and was able to rely on the key reforms adopted in 2019. The GME was repurposed to monitor the impact of the pandemic in a holistic manner, and the IAIS supervisory material sets out the necessary toolkit that insurance supervisors should be equipped with in order to help assess and mitigate systemic events like Covid-19.

11 See FSB (2019).

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