FSB FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

American Council of Life Insurers (ACLI)

Recommendation 1

1. **Is the description of the financial stability risks from leverage in NBFI accurate and comprehensive? Are there additional vulnerabilities or risk dimensions related to NBFI leverage that authorities should consider for monitoring purposes?**

   The ACLI reiterates from prior comments to FSB that NBFI guidance and related recommendations group insurers who have robust regulatory requirements with other NBFIs with more limited oversight. Insurance companies are subject to highly sophisticated, comprehensive, and stringent regulatory oversight at the state level. The state-based framework includes conservative capital and reserving requirements. The framework has proven its effectiveness through multiple financial crises. It provides regulatory protection for insurance policyholders and regulatory stability for the insurance industry. The state regulation imposed on insurers includes mandatory minimum capital levels, group supervision, permissible and prohibited investments and related investment management activities, affiliate transactions, reinsurance agreements, mandatory reporting of financial information, mandatory examinations by regulators, and certain public disc are various mechanisms in place in the rare event of a life insurer impairment or insolvency. State regulators have the authority to take supervisory and/or corrective action against an insurer at the first sign of financial trouble to help prevent it from failing. These regulators have various tools at their disposal that they can deploy when an insurer's reserves, asset/liability ratios and/or risk-based capital levels fall below certain levels. If these preliminary actions are ineffective at stabilizing the company, the regulator would then file a motion with the applicable court to place the insurer into rehabilitation with the goal of bringing the insurer back to financial strength and normal operations. If the rehabilitator determines that the rehabilitation plan is unable to turn the company around, it would then file another motion with the court to place it into liquidation. The liquidator would then marshal and attempt to sell the insurer's estate assets, while the state guaranty associations would either (1) transfer their resident policyholders' policies and contracts to another carrier(s) or (2) provide covered benefits to them based on their state's guaranty association laws. The guaranty associations would then assess their other member insurers to the extent covered benefits exceed the amount of available estate assets.

   The complexity of regulation designed to incentivize prudent management of risks through certain assets and leverage is an important distinction to make for insurers. Other NBFIs utilize those assets and leverage in different ways, therefore, we urge the FSB to recognize

these differences at the outset of consultations and guidance. Insurers may fit the definition of a NBFI, but our risk management varies greatly from other NBFIs. We'd like to point out that the consultation takes the view that leverage providers and leverage users are banks and NBFI in separate, respective roles. Banks operate as both leverage providers and users and not exclusively as leverage providers.

2. **What are the most effective risk metrics that should be considered by authorities to identify and monitor financial stability risks arising from NBFI leverage?**

We point to the comprehensive and coordinated regulation of insurers in the United States as an effective system to monitor risks and financial stability for insurers as NBFIs. The U.S. has implemented among other measures, mandatory clearing and enhancements to margin after the Global Financial Crisis ("GFC") of 2008. At the state level, insurers are precluded from taking significant leverage per NAIC model code (Models #280 and #282) on derivatives which is widely adopted across the U.S. For example, NAIC Model #282 requires insurers to obtain approval to their domiciliary regulator for internal controls, derivatives trading guidelines, credit risk limits, and more requirements. Model #280 restricts the types of investments insurers can make based on their line of business (Health, Life and Property & Casualty). Both models require and address different prudent risk management processes pertaining to leverage. Life insurers are required to file Derivatives Use Plans ("DUPs") with state regulators. Regarding crowded risk exposures, insurers report aggregate information on investments to the Federal Reserve but have more rigorous state regulatory requirements. The NAIC's Own Risk and Solvency Assessment ("ORSA") was established as a modernization initiative on solvency requirements as a response to the GFC. ORSA requires insurers to perform, at least on an annual basis, an assessment of the adequacy of its risk management framework, projected solvency position, and document the process and results of the assessment which receives regulatory oversight. The NAIC designed the ORSA to require thorough analysis of all reasonably foreseeable and material risks to the insurer (i.e., underwriting, credit, market, operation, liquidity risk, etc.). ORSA is an ongoing process rather than a one-time test of insurers' Enterprise Risk Management (ERM) framework. Derivatives are not used in the traditional sense as leverage for insurers. Insurers primarily use derivatives to hedge risks in three ways: 1) fair value hedges to offset assets or liabilities, 2) cash flow hedges to offset variability in future cash flows, and 3) hedges to offset FX risk. Insurers are permitted to use derivatives for asset replication (e.g., CDS paired with a highly rated fixed income security) and income generation (e.g., covered calls on owned securities) but need to back those positions with cash. Derivative use associated with asset replication and income generation is subject to strict regulatory limits for insurers. As a part of the robust state-based regulatory system in the U.S., insurers provide extensive public transparency through quarterly and annual financial reporting. This reporting includes detailed information on investment holdings and derivative positions. Insurers are also subject to SEC and CFTC large position reporting requirements. These requirements and capital reserve and risk-based capital requirements prevent failures in the life insurance industry.

3. **What are the most effective metrics for the monitoring of financial stability risks resulting from:**

(i) specific market activities, such as trading and investing in repos and derivatives

For all three sections, the FSB should encourage jurisdictions to promote strong counterparty credit risk evaluation by all market participants, including banks and NBFIs.

We strongly recommend the FSB consider existing requirements and monitoring in place for specific types of NBFIs like insurers, see our response to Q2. Existing restrictions on life insurers regarding the types of derivatives life insurers utilize should be considered as part of a counterparty credit risk assessment. Rather than parsing out targeted markets or areas, we encourage FSB to evaluate its goals and tailor the solution to that end.

(ii) specific types of entities, such as hedge funds, other leveraged investment funds, insurance companies and pension funds

(iii) concentration and crowded trading strategies

Recommendation 3

4. **What types of publicly disclosed information (e.g. transaction volumes, outstanding amounts, aggregated regulatory data) are useful for market participants to enhance their liquidity or counterparty credit risk management? Are there trade-offs in publicly disclosing such information and, if so, what would be the most important elements to consider? What is the appropriate publication frequency and level of aggregation of publicly disclosed information?**

The FSB should consider the significant trade-offs for public disclosure (in particular, real-time or near real-time disclosures). One major concern is the potential for market participants to front-run trades based on the disclosed data. Real-time or near real-time public disclosures can negatively impact those executing large directional hedging portfolios like insurers. Therefore, it is essential to weigh the benefits of public disclosure against the potential adverse effects on market participants. The frequency of publicly disclosed information should be up to the domiciliary regulator for NBFIs. Disclosure should also be considered based on business models of the NBFI or trading strategy and how the information will be utilized in the market. Some trading information should remain proprietary. For those reasons, we caution the FSB against creating a top-down, one-size-fits-all approach to public disclosure.

Recommendation 5

5. **Do Recommendations 4 and 5 sufficiently capture measures that would be used to address the scope of non-bank financial entities under consideration in this report? In what ways may the policy measures proposed in the consultation report need to be adjusted to account for different types of non-bank financial entities?**

It is crucial that the FSB tailors most of these recommendations and policy measures to the respective different types of NBFIs such as insurers. Insurers have different risk management practices and regulatory requirements tailored to specific risk profiles. Compared to other NBFIs, insurers are subject to more intensive regulatory oversight. See responses to questions 1, 2, and 10.

We strongly urge the FSB to carefully analyze how these measures would impact the important risk mitigation activity of hedging. Bona fide hedging activity encompasses strategies that may or may not qualify for hedge accounting treatment. The FSB should not limit hedging to only include those activities that qualify for hedge accounting treatment. As described in prior responses, insurers utilize derivatives for vital hedging activities that should not be discouraged through direct or indirect, activities or entity-based measures.

6. **In what circumstances can activity-based measures, such as (i) minimum haircuts in securities financing transactions, including government bond repos, (ii) enhanced margin requirements between non-bank financial entities and their derivatives counterparties, or (iii) central clearing, be effective in addressing financial stability risks related to NBFI leverage in core financial markets, including government bond markets? To what extent can these three types of policy measures complement each other?**

   We strongly encourage the FSB reconsider whether it is appropriate to implement additional activities-based measures. The percentage of transactions requiring collateral has increased meaningfully since the GFC through both mandatory clearing and uncleared margin rules. The many regulatory reforms, while mitigating counterparty credit risk, raised liquidity costs associated with derivatives positions.

   We firmly believe that the liquidity effects and interconnectivity between the various activities-based measures should be carefully evaluated and should not be implemented in a way that could cause a procyclical event. The effect should be considered for each type of market participant beyond the broad category of NBFIs.

   The current global rules related to margin on uncleared OTC derivatives, mandatory central clearing of certain derivative instruments, and recent regulatory requirements related to mandatory clearing of repo markets, promote effective counterparty risk mitigants across all market participants. Any additional requirements should be bilaterally negotiated between parties as they may have counterparty credit risk, liquidity, or capital considerations. Top-down margin rules should not disadvantage one set of market participants (NBFIs) over another.

   Bilaterally negotiated incremental measures should also be tailored to the specific business model of the NBFI. Tailoring these requirements to the unique risk profiles of different assets and counterparties ensures that they are more effective in mitigating risks without causing unnecessary disruptions.

7. **Are there benefits to dynamic approaches to minimum margin and haircut requirements, e.g. where the requirements change based on changes in concentration or system-wide leverage? If so, what types of indicators capturing concentration or system-wide leverage should the requirements be linked to?**

   Dynamic approaches to margin and haircut requirements introduce procyclicality concerns into the safety and soundness of the financial system. Namely, dynamic approaches could potentially have a significant impact on the liquidity needs related to supporting bona fide hedging purposes. Margin requirements need to be properly calibrated to balance the counterparty credit risk mitigation benefits of enhanced margin versus the additional liquidity requirements that they impose. We oppose dynamic margin requirements based on system-wide leverage indicators because insurers would not be able to properly project and manage liquidity needs.

8. **Are there any potential unintended consequences from activity-based measures beyond those identified in the consultation report?**

9. **For non-centrally cleared securities financing transactions, including government bond repos, what are the merits of margin requirements compared to minimum haircuts?**

10. In what circumstances can entity-based measures, such as (i) direct and (ii) indirect leverage limits be effective in addressing financial stability risks related to NBFI leverage in core financial markets?

We oppose direct leverage limits. The ACLI wants to make clear that the theme throughout the consultation that implies leverage causes more speculative activities and produces more systemic risk does not hold true for insurers due to the enhanced regulatory requirements they face at the state and federal level.

Life insurers' main regulators evaluated direct leverage limits as an option and came up with other solutions that allowed for insurers' evolving needs depending on liquidity risk and other considerations. As a result, life insurers submit Derivatives Use Plans (DUPs), perform asset testing, have restrictions on which derivatives insurers can purchase under the broad adoption of the NAIC Investments of Insurers Model Act, and need to disclose internal control, investment strategy and other information to their domiciliary regulator. Life insurers also need to comply with a variety of indirect measures that produce incentives for investing in certain ways. The Risk-Based Capital Charges applied to a variety of assets incentivizes prudent investing behavior for insurers. There are additional requirements outlined in our responses to questions 1 and 2.

We also strongly caution against direct leverage limits because leverage provides the option for liquidity in times of stress or volatility. Putting an arbitrary direct limit on leverage can inhibit bona fide hedging activity and could cause indirect systemic risk to global markets.

It is vital that the measures regulators propose are not implemented as a response to an idiosyncratic market stress. Disrupting the balance of measures could have consequences such as limiting other methods for NBFIs to respond to liquidity needs and potentially create a procyclical event that exacerbates economic fluctuations.

11. Are there ways to design and calibrate entity-based measures to increase their risk sensitivity and/or their effectiveness in addressing financial stability risks from NBFI leverage?

12. Are there any potential unintended consequences from entity-based measures beyond those identified in the consultation report?

Since the GFC, significant enhancements have been made to our financial regulatory system in the US. Anything imposing further limits should be bilaterally negotiated. We encourage regulators perform a balancing act of clearing requirements and liquidity needs. Entity-based measures implemented broadly across all NBFIs could negatively impact the agility of insurers' liquidity needs in times of stress. We also point out that limiting derivatives use for insurers has a broad impact on insurers utilization of derivatives as a hedging mechanism to support liabilities policyholders.

13. To what extent can activity-based and entity-based measures complement each other? What are the main considerations around using these two types of measures in combination?

We want to reiterate that insurers are primarily regulated through the coordinated state-based regulatory system which primarily focuses on activities-based measures but combines entity-based measures to encourage good asset management and management of leveraged positions. We refer you to our response to questions 2 and 10.

Recommendation 6

14. **How could counterparty credit risk management requirements for leverage providers be enhanced to be more effective in addressing financial stability risks from NBFI leverage in core financial markets, such as government bond repo markets? In what circumstances can they be most effective?**

    It is important to note that leverage users as defined here also have counterparty credit risk related to these transactions. For example, in the event of a bank counterparty default, insurers will have to quickly find alternative counterparties to replace derivatives used to hedge risks on their balance sheet.

Recommendation 7

15. **Would a minimum set of disclosures to be provided by leverage users to leverage providers be beneficial in improving counterparty credit risk management and reducing financial stability risks from NBFI leverage, including concentration risks? If so, which types of information and what level of granularity should (and should not) be included in this minimum set and why?**

    The types of disclosures necessary between a leverage user and provider depend on what is relevant to the parties, their risk profiles, the type of assets, and existing regulatory requirements. Certain information disclosures may constitute material non-public information, and this may inhibit the activity that can be conducted. We strongly encourage the FSB reconsider the high level of granularity proposed in its recommendations regarding these disclosures and instead offer principles to guide market participants in conducting effective counterparty credit risk assessments.

16. **What are the main impediments that leverage users face in sharing additional or more granular data with their leverage providers? Is there a risk that a minimum recommended set of disclosures may lead leverage users to limit the information they share with their leverage providers to that minimum set?**

    See response to question 15.

17. **Should such a minimum set of disclosures rely on harmonised data and metrics to ensure transparency and efficiency in the use of such information for risk management purposes? Do respondents agree that such a minimum set of disclosures should be based on the list of principles outlined in the consultation report? If not, which principles should be added, deleted or amended?**

18. **Should leverage users be required or expected to provide enhanced disclosures (beyond that provided in normal market conditions) to their leverage providers during times of stress?**

    No, any enhanced disclosures between parties need to be bilaterally negotiated. Please see our responses to questions 2 and 10.

19. **Should authorities design a minimum set of harmonised disclosures and guidelines on its application, or should they convene a cross-industry working group to do so? How do respondents believe such a standard should be incorporated into market practice? Through regulation, supervisory guidance, and/or via a Code of Conduct or similar approach?**

Recommendation 8

20. Are there areas where the principle of “same risk, same regulatory treatment” should be more consistently applied? Are there circumstances in which the principle should not apply or should not apply comprehensively?

The ACLI has been publicly supportive of U.S. insurers’ domestic regulators taking an approach where assets with similar risks should produce similar regulatory outcomes. However, as we’ve established in our prior responses, insurers use derivatives and other assets very differently from other NBFIs. For example, insurers use derivatives in a different way than hedge funds utilize derivatives. In addition, the way insurers use assets like money market funds is different from other entities as well. We caution against broadly applying the “same risk, same regulatory treatment” across all NBFIs for that reason because the outcome can be more harmful for more highly regulated industries like the life insurance industry.