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Are Insurers Systemically Important

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Jacques.Tremblay@oliverwyman.com

Simone.Brathwaite@oliverwyman.com

Terminology definitions

- **Systemic importance:** “the significance of a financial institution to the continued stability of the financial system and the real economy; the impact of an institution’s failure or severe distress increases with their systemic importance”
 - The Financial Stability Board's definition of Systemically Important Financial Institutions (SIFIs) is those “*whose disorderly failure...would cause significant disruption to the wider financial system and economic activity*”¹
 - The Basel Committee on Banking Supervision (BCBS) states that: “*global systemic importance should be measured in terms of the impact that a bank’s failure can have on the global financial system and wider economy*”²



1. FSB, Reducing the moral hazard posed by systemically important financial institutions, 20 October 2010
2. BCBS, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013

Following the financial crisis, supervision of global systemically important financial institutions intensified

- Following the global financial crisis, the Financial Stability Board (FSB) and the G-20 leaders prioritized more intense and effective supervision of financial institutions, in particular focusing on global systemically important financial institutions (G-SIFIs)
 - In November 2011 the Basel Committee of Banking Supervision (BCBS) issued their rules text and assessment methodology for global systemically important banks (G-SIBs)
 - In July 2013 the International Association of Insurance Supervisors (IAIS) issued their assessment methodology used to identify global systemically important insurers (G-SIIs)
 - The 2013 methodology was indicator-based and premised upon the BCBS's G-SIB methodology.
 - However, the specific nature of the insurance sector has influenced the selection, grouping, and weights assigned to certain indicators
- **Throughout this work, banks and insurers have been assessed separately**, taking into consideration their different business models and treating them on their own merits in the systemic risk discussion
 - Banks are involved in maturity transformation, funding their business with short-term liquid liabilities (e.g. customer deposits) and providing long-term funding to households and corporates – a vital role in the real economy, but one which involves inherent liquidity risk
 - In contrast, traditional insurance activities (pooling idiosyncratic risks from policyholders) are not viewed as generating or amplifying systemic risk within the financial system or in the real economy^{1,2}
 - Only insurers that engage in non-traditional or non-insurance activities can be *“more vulnerable to financial market developments and may therefore be more likely to amplify, or contribute to, systemic risk, than traditional insurers”*¹
- Updated lists of G-SIBs and G-SIIs are published annually by the BCBS and the IAIS respectively, with the assessment methodology used being reviewed at least every three years



1. IAIS, Global Systemically Important Insurers: Initial Assessment Methodology, 18 July 2013
2. Geneva Association (is the leading international insurance “think tank” for strategically important insurance and risk management issues), Considerations for Identifying Systemically Important Financial Institutions in Insurance, April 2011

Nine insurers identified as global systemically important insurers (G-SIIs)¹

Supervisors have also started to consider domestic systemically important financial institutions

- For 2015, after consideration of the IAIS' s annual G-SII assessment exercise and following consultation with the IAIS and national authorities, the FSB has decided to identify nine primary insurers as G-SIIs, using end-2014 data and the methodology published by the IAIS in July 2013, and the policy measures that apply to them, including
 - A higher loss absorbency requirement
 - Requirements for enhanced group-wide supervision, including for the group-wide supervisor to have direct powers over holding companies and to oversee the development and implementation of a Systemic Risk Management Plan and a Liquidity Management plan
 - Requirements for group-wide resolution planning and regular resolvability assessments
- The FSB has also begun to look at extending the framework on G-SIFIs to consider the treatment of domestic systemically important banks (D-SIBs)
 - In October 2012 the BCBS published a framework for dealing with D-SIBs stating that “*National authorities should establish a methodology for assessing the degree to which banks are systemically important in a domestic context*”¹
 - The principles align with those developed for G-SIBs but also allow for “*appropriate national discretion to accommodate structural characteristics of the domestic financial system*”¹
 - At present, a framework for dealing with domestic systemically important insurers has not been outlined; given the narrative around the lower systemic risk posed by global insurers, it is not clear if such a framework will even be proposed



1. Aegon N.V, Allianz SE, American International Group, Aviva plc, AXA SA, MetLife Inc, Ping An Insurance Group, Company of China, Prudential Financial Inc, Prudential plc

International Association of Insurance Supervisors (IAIS) GSIFI assessment framework

Assessment framework for global insurers

Category (weightings)	Description	Indicator	Weight
Non-traditional insurance and non-insurance activities (45%)	Systemic risk posed by businesses outside of traditional insurance business	Non-policy holder liabilities and non-insurance revenue	6.4%
		Derivatives trading	6.4%
		Short-term funding	6.4%
		Financial guarantees	6.4%
		Minimum guarantee on variable insurance products	6.4%
		Intra-group commitments	6.4%
		Liability liquidity	6.4%
Interconnectedness (40%)	Direct and indirect links to financial sector	Intra-financial assets	5.7%
		Intra-financial liabilities	5.7%
		Reinsurance	5.7%
		Derivatives	5.7%
		Large exposures (e.g. largest counterparties, sovereign holdings)	5.7%
Size (5%)	Share of financial services provided/ insurance market covered	Turnover	5.7%
		Level 3 assets	5.7%
		Total assets	2.5%
Substitutability (5%)	Ease of replacement of a failed party as either market provider or participant	Total revenues	2.5%
		Premiums for specific business lines	5%
Global activity (5%)	Significance of cross-border operations	Revenues outside home country	2.5%
		Number of countries	2.5%
Total			100%



Source: IAIS - Global Systemically Important Insurers: Initial Assessment Methodology (2013)

Insurance industry view on regulatory indicators of systemic importance¹

The FSB/IAIS criteria need to be applied to risk activities rather than to financial institutions as a whole – focusing on a list of institutions is unlikely to detect or manage systemic risk effectively

Systemic Risk Assessment Framework – Systemic Importance indicators (impact criteria)

Category (weightings)	Description	Regulator's Rationale	Insurance industry view
Size	<ul style="list-style-type: none"> The size of a financial institution relative to the financial system and local economy 	<ul style="list-style-type: none"> An institution's distress or failure is more likely to damage the local economy or financial markets if it represents a large share of the system itself¹ Distress or failure of a large institution is also more likely to damage confidence in the financial system as a whole 	<ul style="list-style-type: none"> A crude measure of risk, if no account is taken of economic risk capital since assets do not measure risk In an insurance context, size is a prerequisite for the effective pooling and diversification of risks. This indicator should measure the absolute size of the FI's potentially systemically risky activities not the FI itself
Inter-connectedness	<ul style="list-style-type: none"> The extent to which a financial institution is directly linked to other institutions (via cross ownerships, payment systems, derivatives) 	<ul style="list-style-type: none"> As an institution's interconnectedness increases, its distress or failure becomes more likely to trigger distress at other financial institutions, causing contagion and financial instability 	<ul style="list-style-type: none"> A necessary condition for systemic relevance There is no direct connection between the insurer and the payment systems which insurers access as users, but not as organizers. The typical "core" activities of insurers do not characterise interconnectedness
Substitutability/ financial system infrastructure	<ul style="list-style-type: none"> The degree to which a financial institution's role within the financial system could be replaced if it were to fail 	<ul style="list-style-type: none"> The systemic impact of an institution's distress will be larger where other institutions cannot easily provide the same or similar services to cover any sudden gaps in service This includes the provision of financial system infrastructure (e.g. payment systems) and also cases of large market share in particular business lines 	<ul style="list-style-type: none"> Due to the organisation and structure of the insurance and reinsurance market, substitutability is not as relevant for insurers as banks, where exchanges and payment systems are critical No insurer has a monopoly or has a unique role that others could not step in with sufficient capacity. Reinsurers offer global capacity for catastrophic event Insurance claims are slower than margin calls, collateral etc. offering time to identify viable substitutes, which mitigates impact of an insolvency event or systemic importance
Complexity/Non-Traditional Insurance	<ul style="list-style-type: none"> The complexity of a financial institution's balance sheet and business practices 	<ul style="list-style-type: none"> The systemic impact of a financial institution's failure will be related to its overall complexity as this will require greater costs and time to resolve the institution 	<ul style="list-style-type: none"> Agree, that focus should be on complex, non-traditional activities

Industry does not dispute the criteria, but advocates applying criteria to specific activities and not indiscriminately to the institutions for many reasons including preventing reg. arbitrage



1. Geneva association reports 2010 and 2011
2. It should be noted that both the BCBS and IAIS assess inter-connectedness of global banks and insurers on an aggregated rather than name-level basis, as data on cross-institutional exposures needed to examine direct and second order linkages between G-SIFI counterparties is not systematically collected

Section 2

Oliver Wyman view and framework



Oliver Wyman view: a systemic risk assessment of any financial institution should consider not only systemic importance but also probability of failure

- Oliver Wyman assesses systemic risk using frameworks that build upon assessment methodologies used by the FSB, BCBS and IAIS, and that has been tailored to the local market
- Similar to the Geneva Association, it is also our view that the systemic risk of a financial institution is not a function of their regulatory license (insurer vs bank) but more importantly it is a function of their size, complexity of their activities, interconnectedness, speed and effectiveness of their risk management and governance
- It is also our view that the overall “systemic risk” that an institution poses is a combination of its **systemic importance and its probability of failure**
- Given that it should be activity based we have developed a framework that is tailored to the local financial system, and can be applied to both banks and insurers
- Our framework uses an indicator-based approach, in line with global assessments by the BCBS and IAIS
 - This provides an effective way to assess systemic risk by covering a wide set of contributing factors
 - This leads to relatively stable results across time, in contrast to other, more sophisticated methodologies, such as network analysis and portfolio models, where findings are conditional on market confidence
 - This draws on readily available data to conduct a macro-financial assessment, as other approaches, such as a network analysis of cross-institutional links, face information gaps even in the most advanced regulatory regimes

Oliver Wyman framework takes into consideration *systemic importance* which has been the focus of supervisory developments thus far, but and also takes into consideration the *probability of failure* which has received less attention



Terminology definitions refinement

- **Systemic importance:** “the significance of a financial institution to the continued stability of the financial system and the real economy; the impact of an institution’s failure or severe distress increases with their systemic importance”
- **Probability of failure:** “the likelihood that a financial institution will fail or get into severe distress (i.e. be unable to meet substantial contractual obligations)”
 - Geneva Association’s definition of failure: “*the moment when the insurer [financial institution] is unable to meet substantial contractual obligations, or supervisors need to impose dramatic preventative actions to reduce the extent or probability of such a situation in the near future.*”³

An institution’s “systemic risk” can be thought of as the combination of its systemic importance and its probability of failure



1. FSB, Reducing the moral hazard posed by systemically important financial institutions, 20 October 2010
2. BCBS, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013
3. Geneva Association, Insurance and Resolution in Light of the Systemic Risk Debate, February 2012

Oliver Wyman framework builds on international methodologies and is applicable to both banks and insurers

Systemic importance

- The methodology used to assess systemic importance builds upon the approaches used to assess G-SIBs, G-SIIs and D-SIBs, is tailored to the local market and could be universally applied to major local institutions including both banks and insurers
- An indicator-based methodology is used, in line with global assessments by BCBS and IAIS, as it provides an effective way to cover a wide set of contributing factors
- While the systemic importance of domestic insurance institutions could be debated, for the purposes of this assessment our framework is such that it is applicable to both banks and insurers
- **It should be noted that no assessment approach can perfectly measure systemic importance**
- Instead it can only be inferred through the use of a series of quantitative “indicators”
- Qualitative information also should be considered, as acknowledged by the BCBS¹ and the IAIS² in their incorporation of supervisory judgment into their approaches

Probability of failure

- A framework is provided to give an indication of the probability of failure of an institution
- Quantification of a “probability of default” would require more detailed modelling than desired for the purposes of this framework
- As such, the approach includes both quantitative and qualitative elements to give an indication of, but not measure, probability of failure



1. BCBS, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013
2. IAIS, Global Systemically Important Insurers: Initial Assessment Methodology, 18 July 2013

Oliver Wyman's framework assesses systemic importance using quantitative indicators across four categories

Systemic Risk Assessment Framework – Systemic Importance

Category	Description	Rationale	Mitigating actions
Size	<ul style="list-style-type: none"> The size of a financial institution relative to the financial system and local economy 	<ul style="list-style-type: none"> A financial institution's distress or failure is more likely to damage the local economy or financial markets if it represents a large share of the system itself¹ Distress or failure of a large institution is also more likely to damage confidence in the financial system as a whole 	<ul style="list-style-type: none"> Ensuring clear legal separation and accountability of duties Recovery Plan and a Resolution Plan
Inter-connectedness	<ul style="list-style-type: none"> The extent to which a financial institution is directly linked to other institutions (e.g. through contractual obligations) at an aggregated level² 	<ul style="list-style-type: none"> As a financial institution's interconnectedness increases, its distress or failure becomes more likely to trigger distress at other financial institutions, causing contagion and financial instability 	<ul style="list-style-type: none"> Risk appetite limits, reporting and sensitivities for the combined business Recovery Plan and a Resolution Plan to address any concerns around cross-jurisdictional contagion
Substitutability/ financial system infrastructure	<ul style="list-style-type: none"> The degree to which a financial institution's role within the financial system could be replaced if it were to fail 	<ul style="list-style-type: none"> The systemic impact of a financial institution's distress will be larger in cases where other institutions cannot easily provide the same or similar services to cover any sudden gaps in service This includes the provision of financial system infrastructure (e.g. payment systems) and also cases of large market share in particular business lines 	<ul style="list-style-type: none"> Clear ERM requirements at the holding company level: combined risk appetite, risk reporting, stress and scenario testing
Complexity/Non-Traditional Insurance	<ul style="list-style-type: none"> The complexity of a financial institution's balance sheet and business practices 	<ul style="list-style-type: none"> The systemic impact of a financial institution's failure will be related to its overall complexity as this will require greater costs and time to resolve the institution 	<ul style="list-style-type: none"> Recovery Plan (includes consideration of liquidity stress scenarios)

Articulated Board approved mitigating actions and planning serve to reduce systemic importance (the impact to the system on failure) and should be reflected in assessments

1. However, it should be noted that for insurance businesses size is a prerequisite for the effective pooling and diversification of risks
2. It should be noted that both the BCBS and IAIS assess inter-connectedness of global banks and insurers on an aggregated rather than name-level basis, as data on cross-institutional exposures needed to examine direct and second order linkages between G-SIFI counterparties is not systematically collected



Probability of failure is also assessed, but with a greater need for use of qualitative factors

Systemic Risk Assessment Framework – Probability of failure

Category	Description	Rationale	Mitigating actions
Capital	<ul style="list-style-type: none"> The level of capital adequacy of a financial institution 	<ul style="list-style-type: none"> Capital is a source of financial support to protect an institution against unexpected losses, and is, therefore, a key contributor to its safety and soundness 	<ul style="list-style-type: none"> Ensuring clear legal separation Recovery Plan and a Resolution Plan
Risk Profile	<ul style="list-style-type: none"> The profile of different risks that a financial institution is exposed to, including an institution's sensitivity to market risks – note, this assessment is in part qualitative given data restrictions This includes consideration of concentrations, correlations, and cross-jurisdictional activities (the extent to which a financial institution's balance sheet and business operations are spread across multiple countries) 	<ul style="list-style-type: none"> A financial institution with highly concentrated exposures and a high sensitivity to particular market risks is at greater risk of suffering financial distress from a single adverse extraneous event (e.g. currency collapse, property market crash) This includes the risk of contagion from other, more vulnerable economies. Cross-jurisdictional financial sector linkages can also makes the resolution of a failed institution more difficult or complex to complete 	<ul style="list-style-type: none"> Risk appetite limits, reporting and sensitivities for the combined business Recovery Plan and a Resolution Plan to address any concerns around cross-jurisdictional contagion
Management	<ul style="list-style-type: none"> A financial institution's internal controls and management's ability to identify, measure, monitor and control risk 	<ul style="list-style-type: none"> A financial institution's control environment and its management's ability to identify, measure, monitor and control risk are key factors in determining the likelihood that it will get into financial distress 	<ul style="list-style-type: none"> Clear ERM requirements at the holding company level: combined risk appetite, risk reporting, stress and scenario testing
Liquidity	<ul style="list-style-type: none"> The ability of a financial institution to meet present and future cash flows without adversely affecting daily operations or incurring unacceptable losses 	<ul style="list-style-type: none"> A financial institution with severe asset/liability maturity mismatches, in particular an excess of short-term liabilities, is at greater risk of financial distress as a result of a liquidity stress event 	<ul style="list-style-type: none"> Recovery Plan (includes consideration of liquidity stress scenarios)

Quantitative indicators and qualitative commentary underlie the different categories, with the focus on assessing the risk associated with the individual institution



Higher loss absorbency requirements is not a catch-all; effective risk governance and risk management controls can be more relevant

- Whilst more capital reduces the probability of failure of a specific institution, for a well capitalized financial institution we see other actions as being more relevant for reducing the systemic risk of an entity
- The negative impact to both systemic importance and the probability of failure as a result can be mitigated through a number of routes but specifically, in our view, by the following actions
 - Ensuring appropriate Enterprise Risk Management capabilities at holding company level and throughout an institution (e.g. risk appetite cascaded to limits, appropriate risk governance and reporting) will help to manage the risk profile and reduce the probability of failure
 - Putting in place a Recovery Plan (owned by management) would outline clear actions to take in stress scenarios to help prevent the combined entity from getting into severe distress, i.e. **it will lower the probability of failure**
 - Putting in place a **Resolution Plan (owned by the “resolution authority”)** would outline clear details of how the institution would be resolved in an orderly fashion if it were to fail, i.e. it will minimize the impact of failure and by implication the systemic importance
- Overall systemic risk of an institution can be impacted by the actions taken by management to reduce the systemic risk of the entity



1. The limitations of relying solely on capital are also recognized by regulators: "stricter rules, like substantially higher capital requirements, can create a false sense of security; an institution will never have enough capital if there are material flaws in its risk management practices" Julie Dickson, Head of OFSI, 23 August 2012

The framework can also support the assessment of systemic risk for an individual institution on an on-going basis

Business As Usual assessment

Systemic importance

1 Annual assessment using quantitative indicators and as required by management

- Annual calculation of the indicators underlying the assessment (see Appendix 1) to track systemic importance over time
- Calculated annually due to limitations for data covering the entire financial system
- Assessment also performed for any strategic acquisitions where management deem it necessary, especially local transactions which could impact systemic importance

Probability of failure

2 On-going management of probability of failure through ERM processes

- An institution's probability of failure is best managed through their Enterprise Risk Management (ERM) processes
- This includes a clearly defined risk appetite cascaded to operational limits and on-going reporting of exposure relative to limits
- Along with holding capital, effective risk measurement and management is the best tool for managing potential drivers of failure

Periodic independent review

3 Independent review every 3 years

- Periodic independent reviews by Internal Audit or an objective third party will further assist the management of systemic risk
- Qualitative elements, in particular related to probability of failure, are best assessed by an independent third party
- 3 year reviews to coincide with the review of the methodology used (see item 4)

4 Methodology review at a minimum every 3 years

- In line with G-SIFI assessments, the methodology used should be reviewed at a minimum of every 3 years to ensure it is still fit for purpose
- Significant changes to the financial system or regulatory environment should also prompt review (and potential amendment) of the methodology
- 3 year reviews to coincide with the independent systemic risk assessment (see item 3)

Appendix 1

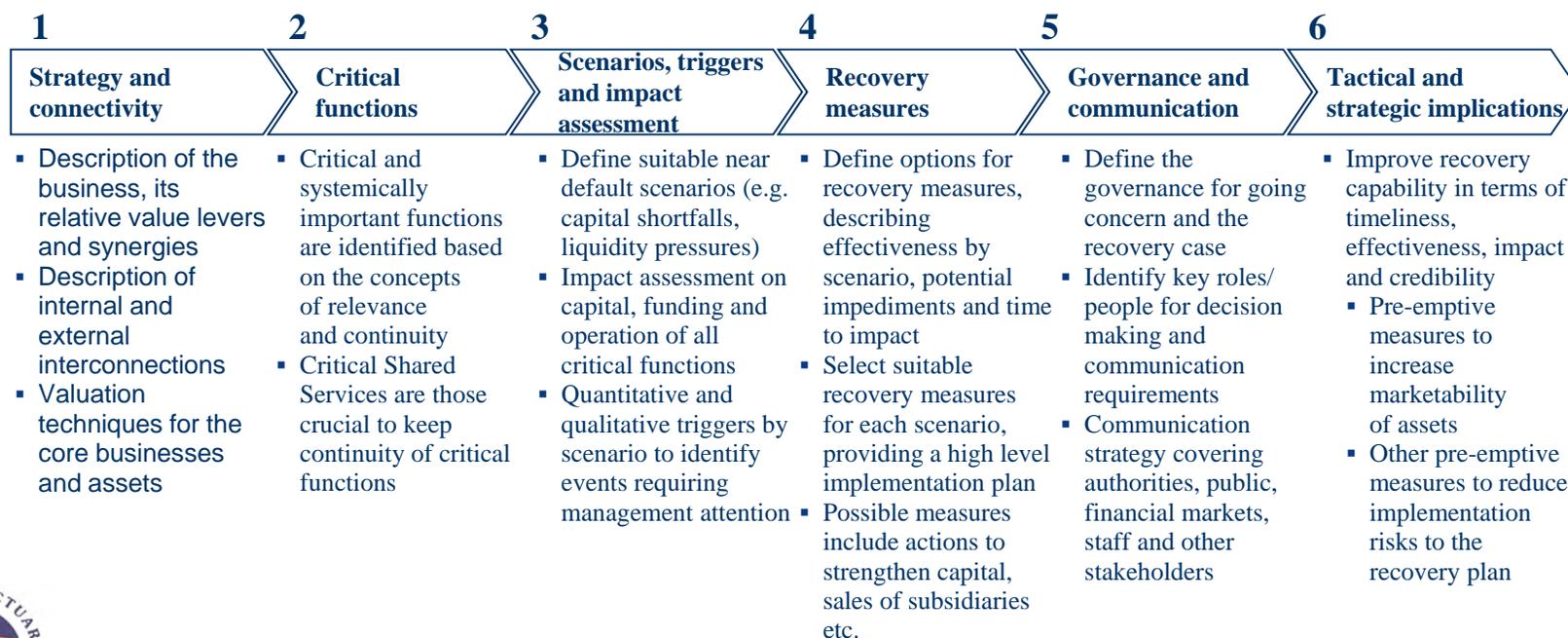
Recovery and Resolution Plans



A Recovery Plan (owned by senior management) Helps to lower the probability of failure

- Aims to prevent an institution from failing – i.e. reduce the probability of failure
- Defines triggers and associated management actions to restore the capital and liquidity position and ensure continuing operations when a firm comes under severe stress
- Tied to stress testing and scenario analysis as well as risk appetite crisis play book
- Reviewed by the resolution authority as part of the overall supervisory process
- Updated regularly and following events that materially change a firm’s structure, operations, strategy or risk profile

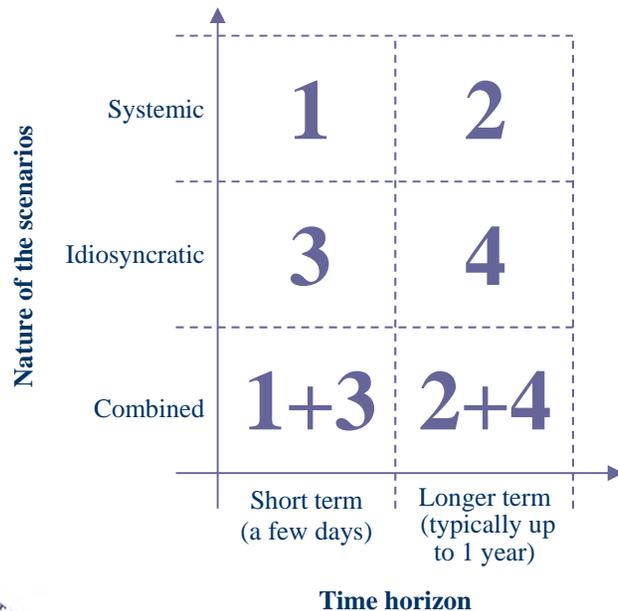
Key areas of activity for a Recovery Plan



A Recovery Plan considers the impacts of several near default scenarios and identifies quantitative and qualitative triggers for management attention

- The potential causes of failure for any given institution are too numerous to list; a single plan of action cannot reflect the full range of stresses or challenges that an institution ends up facing
- Given this, a Recovery Plan needs to be sufficiently flexible to identify and address a range of causes of failure; and should be integrated with internal stress testing frameworks
- The scenarios used should therefore cover different time horizons and both idiosyncratic stresses peculiar to the institution, as well as more general market stresses

Scenario categories (minimum of six)



Observations

- For banks, example scenarios include:
 - Systemic short term: sovereign or big bank default, combined market stress scenario
 - Systemic longer term: macro economic down-turn
 - Idiosyncratic short term: reputational or operational risk events, e.g. bank run (retail or wholesale deposits)
 - Idiosyncratic longer term: continued losses in key businesses, e.g. credit losses or impact of low interest rate environment
 - Scenarios should cover both capital as well as funding related stresses
- Indicators should align with existing stress tests and risk management frameworks, e.g. single name limits, interest rate sensitivities etc.
- For insurers, the scenarios considered are typically different – a liquidity stress is of less relevance, whereas a shock to capital (including consideration of fungibility constraints) can be more significant

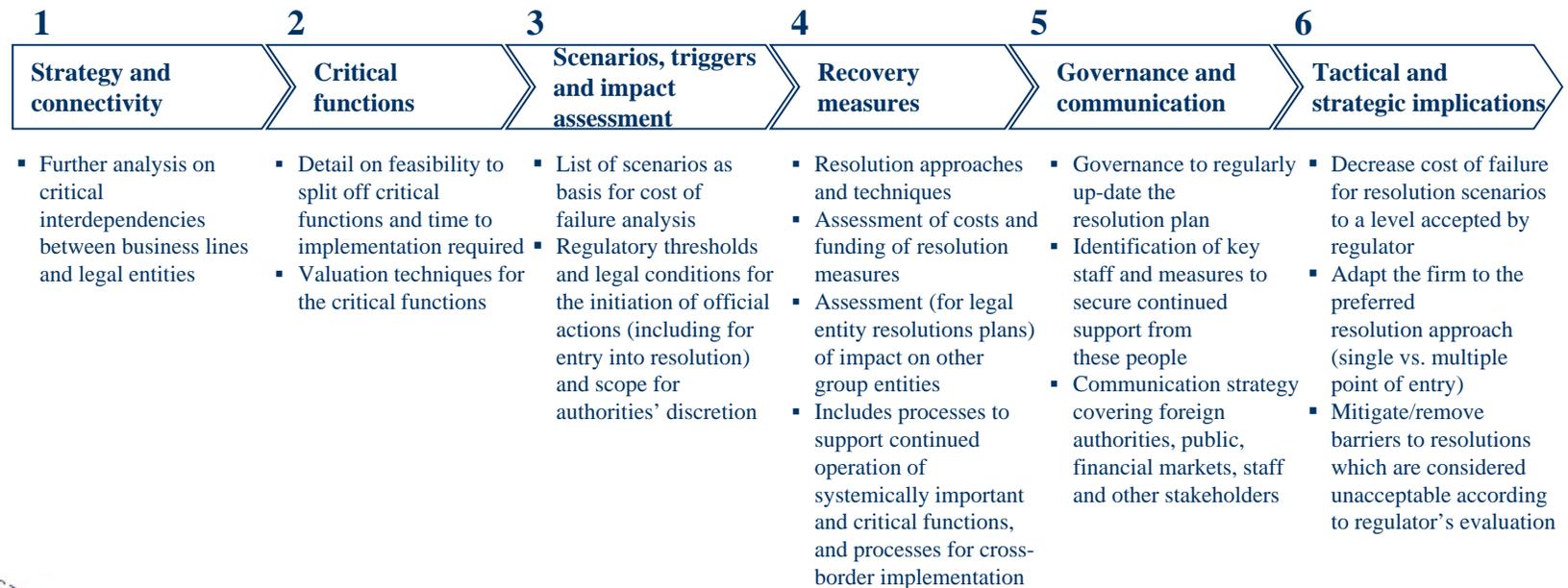
Scenarios used will need to consider stresses impacting both businesses and identify clear triggers to be monitored

Support the drafting of a Resolution Plan (owned by resolution authority)

Helps to minimise the impact of failure on the financial system and economy

- Aims to prepare for orderly resolution in the event of failure, reducing its impact (i.e. systemic importance)
- Prepares for transition to a bridge institution under government or 3rd party ownership, without severe systemic disruption and without exposing taxpayers to loss while protecting systemically important functions
- Responsibility for developing and maintaining the resolution plan lies with the resolution authority
- Firms are required to provide the authorities with the data and information identified as required for resolution planning
- Authorities may review resolution plans with the firms to the extent necessary

Key areas of activity for a Recovery Plan



Appendix 2

BCBS and IAIS assessment frameworks



Basel Committee on Banking Supervision (BCBS) GSIFI assessment framework

Assessment framework for global banks

Category	Description	Indicator	Weight
Size (20%)	Share of financial activities	Total exposure used for Basel III leverage ratio	20%
Interconnectedness (20%)	Financial links to other institutions	Intra-financial system assets	6.66%
		Intra-financial system liabilities	6.66%
		Securities outstanding	6.66%
Substitutability/ FI infrastructure (20%)	Ability to replace bank as either market provider or participant	Custody assets	6.66%
		Payments activity	6.66%
		Underwritten DCM and ECM transactions	6.66%
Complexity (20%)	Simplicity of bank's business, structure and operations	Notional OTC derivative exposure	6.66%
		Level 3 assets	6.66%
		Trading and AFS securities	6.66%
Cross-jurisdictional activity (20%)	Significance of cross-border operations	Cross-border assets	10%
		Cross-border liabilities	10%
Total			100%

- Banks are segmented into GSIFI buckets based on their scores for each indicator
- Indicator scores are calculated as the bank's share of aggregate amount of indicator, summed across all sampled banks
- Cut-off thresholds are assigned to determined final G-SIFI status
- Assessment should occur at the parent company level, reflecting the global impact of failure
- Home regulators can supplement the SIFI assessment with qualitative information in exceptional cases
- Framework is subject to periodic review, to adjust for changes in behaviour incentivised by G-SIFI framework



Source: Basel Committee on Banking Supervision - Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement (2013)

International Association of Insurance Supervisors (IAIS) GSIFI assessment framework

Assessment framework for global insurers

Category	Description	Indicator	Weight
Non-traditional insurance and non-insurance activities (45%)	Systemic risk posed by businesses outside of traditional insurance business	Non-policy holder liabilities and non-insurance revenue	6.4%
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		Financial guarantees	6.4%
		Minimum guarantee on variable insurance products	6.4%
		Intra-group commitments	6.4%
		Liability liquidity	6.4%
Interconnectedness (40%)	Direct and indirect links to financial sector	Intra-financial assets	5.7%
		Intra-financial liabilities	5.7%
		Reinsurance	5.7%
		Derivatives	5.7%
		Large exposures (e.g. largest counterparties, sovereign holdings)	5.7%
		Turnover	5.7%
		Level 3 assets	5.7%
Size (5%)	Share of financial services provided/ insurance market covered	Total assets	2.5%
		Total revenues	2.5%
Substitutability (5%)	Ease of replacement of a failed party as either market provider or participant	Premiums for specific business lines	5%
Global activity (5%)	Significance of cross-border operations	Revenues outside home country	2.5%
		Number of countries	2.5%
Total			100%



Source: IAIS - Global Systemically Important Insurers: Initial Assessment Methodology (2013)