Group governance and recovery planning for insurers

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2020 revisions to the FSA's Supervisory Guidelines

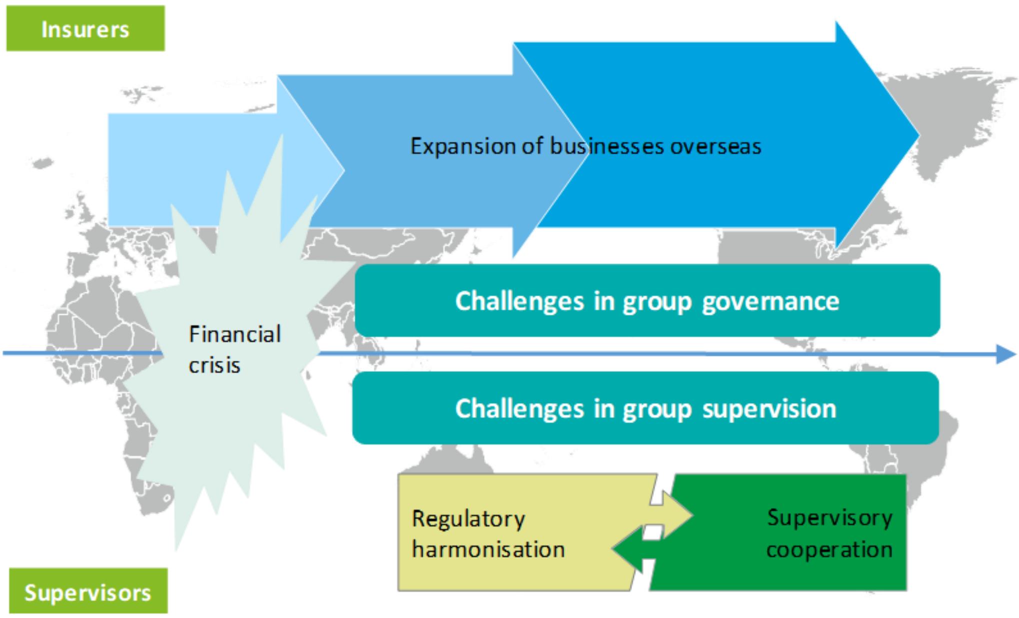
In December 2020, the Financial Services Agency of Japan (FSA) revised the 'Comprehensive Guidelines for Supervision of Insurance Companies (hereinafter referred to as 'Insurance Guidelines'), by which the FSA clarified its perspectives regarding the supervision of insurers on a group basis [*1]. One of the objectives of this update is to incorporate the 'Common Framework for the Supervision of Internationally Active Insurance Groups' (ComFrame) into the FSA's Insurance Guidelines, which the International Association of Insurance Supervisors (IAIS) started to develop in January 2010 following the financial crisis [*2] and finalised in November 2019 [*3].

Two fundamental challenges were revealed by the financial crisis: (i) weak governance and risk management in financial institutions (i.e. challenges in group governance) and (ii) the lack of global harmonisation and cross-border coordination in financial regulation and supervision (i.e. challenges in group supervision) [*4]. Since 2009, financial regulation and supervision have been reformed considerably by, for example, enhancing (i) cross-border supervisory cooperation through the establishment of supervisory colleges, (ii) prudential regulations such as capital regulations, and (iii) supervisory intensity for, in particular, large and complex financial institutions [*5].

In the insurance sector, group supervision perspectives have been adopted early on globally in regulation and supervision. In October 2011, the IAIS comprehensively revised its Insurance Core Principles (ICPs), a set of international standards for insurance supervision [*6], thereby clarifying that the ICPs are applicable not only on a legal entity basis but also on a group basis and significantly strengthening standards for group supervision. These 2011 ICPs form the basis of ComFrame.

In Japan, major insurers have been expanding their businesses overseas in recent years. These insurers, as a result, have faced the huge challenge of strengthening group governance on a global basis. Improving group governance for insurers has been highlighted as one of the supervisory priorities in the FSA's policy papers for the past several years. These revised Insurance Guidelines are expected to lead to full-fledged group supervision in Japan.

Figure 1. Two fundamental challenges revealed by the financial crisis



Source: Developed by the author.

Group governance from the perspective of ComFrame

ComFrame is built on the Insurance Core Principles (ICPs). The ICPs apply to all insurers on both a legal entity and group basis. ComFrame, on the other hand, applies only to large internationally active insurance groups that meet certain thresholds (Internationally Active Insurance Groups or IAIGs). 'Certain thresholds', which are sometimes called 'IAIG selection criteria', are represented by (i) international activity and (ii) size (Figure 2). It is allowed under certain circumstances for the supervisory authority of the home jurisdiction (group supervisor) to not designate an insurance group that meets the selection criteria as an IAIG (opt-out), or to designate an insurance group that does not meet the selection criteria as an IAIG (opt-in).

Figure 2. IAIG selection criteria

Indicator	Thresholds
International activity	■ Premiums are written in three or more jurisdictions ■ Gross written premiums outside of the home jurisdiction are at least 10% of the group's total gross written premiums
Size	■ Total assets are at least USD 50 billion or total gross written premiums are at least USD 10 billion

Source: Adopted from IAIS (2019).

National supervisors, not the IAIS, determine whether an insurer is an IAIG or not. A group supervisor identifies an IAIG in consultation with relevant foreign supervisors. In principle, each group supervisor publishes a list of IAIGs in their jurisdiction, unless unauthorised to do so by the law. The IAIS has compiled all published names as a global list of IAIGs [*7].

It should be noted that whether or not an insurer is an IAIG (i.e. the status as an IAIG) is not an essential point. IAIG selection criteria were established with the expectation that approximately 50 insurers would be selected as IAIGs [*8], and the criteria do not mean anything more than that. In this sense, the approach presented by the FSA in its 'Monitoring Report for IAIGs, etc.' [*9] is considered appropriate: 'The FSA continues to require insurers to strengthen their group governance and group risk management in a manner that is commensurate with their respective size and risk profile, etc., irrespective of whether they are an IAIG or not.' The European Insurance and Occupational Pensions Authority (EIOPA) has published a list of IAIGs in the EU, stating that the list is for informational purposes and should be used only in conjunction with ComFrame [*10].

ComFrame provides high-level principles and standards, not detailed rules, for group supervision. The proportionality principle applies throughout. National supervisors are therefore expected to apply ComFrame in their jurisdiction taking into account the insurers' risk profile, etc. ComFrame is not designed for a particular form of company and is therefore applicable to both public and mutual companies.

ComFrame requirements can be summarised into the following three points: (i) the Head of the IAIG establishes frameworks for governance and risk management on a group basis; (ii) the roles and responsibilities of the Head of the IAIG and relevant entities within the group are clearly defined in these frameworks; and (iii) the effectiveness of these frameworks is ensured. A certain degree of consistency is provided within the group by the establishment of group-wide frameworks by the Head of the IAIG. The effectiveness of these frameworks can be ensured through the application of the PDCA cycle (or the OODA loop). Under an effective framework, information is expected to be provided to those who need it in a timely manner.

'Risk management and internal controls' is one of the most essential elements of the group supervision framework provided by ComFrame (Another important element, 'recovery and resolution', will be addressed later.). ComFrame calls for the establishment of four control functions, i.e. (i) risk management function, (ii) compliance function, (iii) actuarial function, and (iv) internal audit function, as well as the management of risks associated with outsourcing at a group level. As for these four control functions, it is in principle not assumed that multiple functions are integrated. Necessary authority and resources, together with independence, are required to be granted to each function. Insurers need to be able to demonstrate the effectiveness of these control functions on a group basis. As to outsourcing, insurers are expected to manage outsourcing-related risks appropriately, taking an operational resilience aspect into account. Figure 3 shows the relationship between the ICPs and ComFrame. ComFrame requirements are provided for the 10 shaded ICPs out of the 24 ICPs.

Figure 3. Relationship between the ICPs and ComFrame

ICP 1	Objectives, Powers and Responsibilities of the Supervisor	ICP 14	Valuation
ICP 2	Supervisor	ICP 15	Investments
ICP 3	Information Sharing and Confidentiality Requirements	ICP 16	Enterprise Risk Management for Solvency Purposes
ICP 4	Licensing	ICP 17	Capital Adequacy
ICP 5	Suitability of Persons	ICP 18	Intermediaries
ICP 6	Change of Control and Portfolio Transfers	ICP 19	Conduct of Business
ICP 7	Corporate Governance	ICP 20	Public Disclosure
ICP 8	Risk Management and Internal Controls	ICP 21	Countering Fraud in Insurance
ICP 9	Supervisory Review and Reporting	ICP 22	AML/CFT
ICP 10	Preventive Measures, Corrective Measures and Sanctions	ICP 23	Group-wide Supervision
ICP 11	(Merged with ICP 10)	ICP 24	Macroprudential Supervision
ICP 12	Exit from the Market and Resolution	ICP 25	Supervisory Cooperation and Coordination
ICP 13	Reinsurance and Other Forms of Risk Transfer		

Source: Adopted from IAIS (2019).

Group governance and recovery planning

ComFrame requires IAIGs to develop a recovery plan. A recovery plan is defined as 'a plan developed and maintained by the insurer that identifies in advance options for restoring its financial condition and viability under severe stress'. The recovery plan referred to here is a 'pre-emptive' plan. A pre-emptive recovery plan is different from a 'preventive' plan, which aims to prevent a breach of regulatory requirements, or a 'corrective' plan, which aims to recover from situations where the insurer has violated regulatory requirements [*11]. For example, in the event of a breach of solvency requirements, such as PCR (Prescribed Capital Requirements), insurers are required to develop a corrective recovery plan, which is not the pre-emptive recovery plan being discussed here. (In this paper, unless otherwise specified, a recovery plan refers to a pre-emptive recovery plan.)

It is important to understand the relationship between recovery plans, resolution plans, ORSA, and contingency plans. A resolution plan is a plan that identifies in advance options for resolving all or part(s) of an insurer to maximise the likelihood of an orderly resolution, the development of which is led by the supervisory and/or resolution authority in consultation with the insurer in advance of any circumstances warranting resolution. The main focus of a resolution plan is on the resolution of insurers without causing serious disruption to the financial system or exposing taxpayers to loss. ORSA aims to prevent insurers from coming under severe stress, the main focus of which is on assessing the adequacy of risk management and capital on a going concern basis. ORSA is therefore different from a recovery plan in both perspective and objective. A contingency plan is a plan developed by an insurer and prepares in advance the actions and resources needed to limit business disruption and losses resulting from an adverse financial and/or operational event. A recovery plan focuses on severe stress events that may ultimately threaten the viability of the insurer, which is one of the main differences from a contingency plan.

Several jurisdictions require insurers to develop recovery plans. According to the EIOPA, recovery plans are required for: (i) all insurers subject to the Solvency II in Denmark and the Netherlands; (ii) those that exceed certain size thresholds in France, Romania, and Italy; (iii) G-SII and a few other insurers in Germany and the United Kingdom [*12]. Other jurisdictions are also working towards calling for insurers to develop recovery plans. For example, the Bank of Ireland published a consultation document in June 2020 that proposed to require insurers to develop such plans [*13]. The Prudential Regulation Authority (PRA) of the United Kingdom announced in its supervisory priorities for 2021 that it would establish an approach to recovery and resolution planning in 2021 [*14]. In Europe, the EIOPA submitted its opinion to the European Commission in December 2020, in which it stated that insurers meeting certain thresholds should be required to develop recovery plans [*15]. In Australia, the Australian Prudential Regulation Authority (APRA) stated in its 2021 supervison and policy priorities that it would develop new prudential standards for recovery and resolution [*16]. In China, the Chinese Banking and Insurance Regulatory Commission (CBIRC) published in February 2021 draft rules that require banks and insurers to exceed a certain size to develop recovery plans [*17].

Recovery planning is closely related to group governance. The term ‘group governance’ appears not to have an established definition, so this article broadly interprets it as ‘frameworks and mechanisms to ensure financial soundness and the appropriateness of business operations on a group basis’. This includes corporate governance, IT governance, risk governance, and mechanisms and processes for the management of subsidiaries. The FSA’s Insurance Guidelines lists seven elements that should be addressed in a recovery plan (Figure 4). Developing and maintaining a recovery plan that addresses these elements in advance can, for example, help insurers enhance their overall risk management framework, strengthen operational resilience and, consequently, contribute to improving group governance.

Figure 4. Seven elements of a recovery plan

1: Outline of a recovery plan

2: Analysis of the group structure

3: Recovery triggers

4: Analysis of stress scenarios

5: Analysis of recovery options

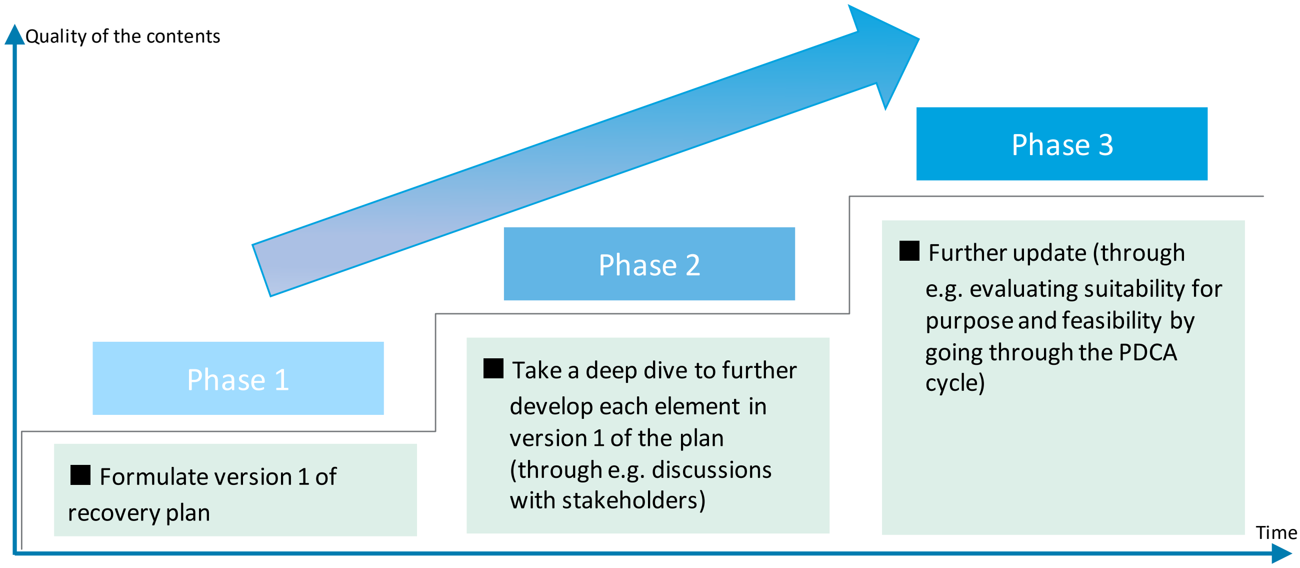
6: Intra-group and external communication

7: Governance for recovery planning

Source: Adopted from FSA (2020a).

The following three points should be particularly noted with regard to the formulation of recovery plans. One is to understand who the stakeholders are. It is important to be aware that not only the group supervisor but also, for example, other relevant foreign supervisors are stakeholders. Recovery plans must meet the expectations of diverse stakeholders. Second, a recovery plan is updated regularly. Figure 5 shows the approach to developing a recovery plan. The review and update process continues beyond Phase 3; there is no ‘final version’ of a recovery plan. Third, and related to the second point, the objective of the recovery plan is not to identify all possible scenarios and corresponding recovery options in advance. A recovery plan is a tool to share an understanding with stakeholders on how to respond to severe stress.

Figure 5. Approach to developing a recovery plan: A phased approach



Source: Developed by the author.

Summary: Strengthening group governance

The FSA has shown its viewpoints for monitoring group governance and risk management in its report published in October 2020. These viewpoints can be summarised as follows.

- Whether the group's overseas business strategies are clearly described in its medium- to long-term business plan
- Whether a governance framework that covers overseas subsidiaries has been developed and is operated appropriately
- Whether the group's strategy is shared within the group
- Whether mechanisms for information sharing between the Head of the IAIG and overseas subsidiaries are in place
- Whether the group has a strategy for developing human resources necessary for expanding businesses oversease
- Whether the group fosters a (risk) culture within the group by setting and sharing the group's philosophy and values

While all of these viewpoints seem to be intended for insurance groups with overseas operations, they are also useful for monitoring the governance and risk management of entirely domestic insurance groups. If, for example, it becomes more commonplace for an insurer to engage in non-insurance business (and vice versa), the number of (domestic) insurance groups with insurance and non-insurance businesses would increase. Consequently, from a supervisory perspective, the importance of group governance would further increase not only in the context of the supervision of international insurance groups but also for the supervision of domestic ones. Furthermore, from the perspective of insurers, it would become increasingly essential to strengthen their group governance.

Finally, as the COSO ERM framework presents (Figure 6), culture is a critical element in building a robust risk management framework [*18]. In order to further strengthen group governance, it will become increasingly important for insurers to share values and foster a (risk) culture within the group.

Figure 6. COSO ERM Framework

Source: COSO (2017). The outline on the far left has been added to the diagram by the author.

Note: Any opinions expressed in this paper are the author's own, and should not be regarded as the official opinions of the organisation to which the author is affiliated.

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Author

Shinya Kobayashi

Director

Centre for Risk Management Strategy

Deloitte Touche Tohmatsu LLC

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