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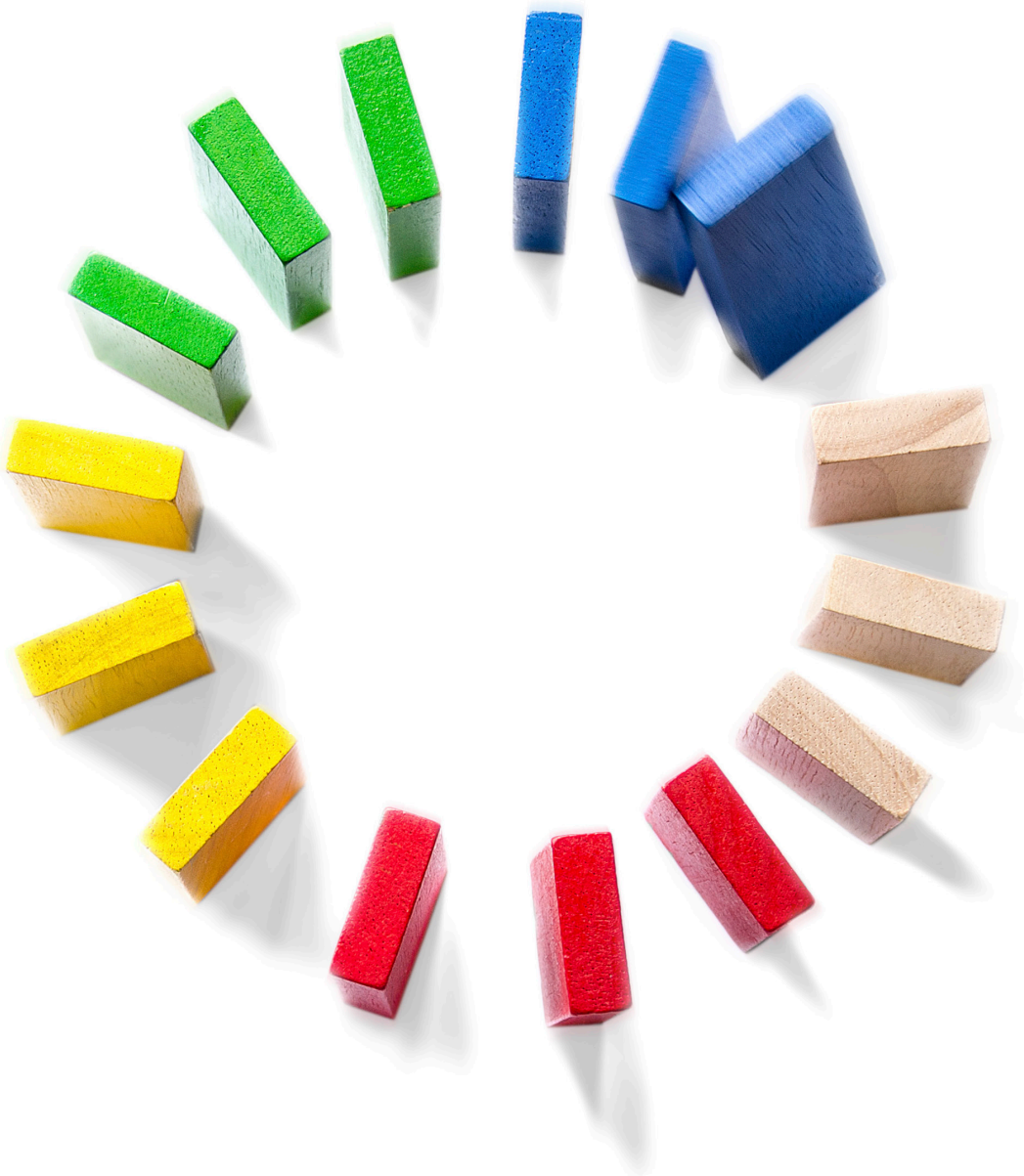


Enhanced insurance prudential standards and global capital regimes

Change on the horizon?

Executive summary

To say insurance regulation is changing is to mouth a cliché, but given the various ways in which regulation seems to be changing, insurers—including those not directly or apparently affected—would do well to prepare contingency plans.

Even as political uncertainty may cloud the future of global regulation, insurance regulators have continued working together to create a supervisory structure that shifts from the previous legal-entity-centric, policyholder-protection-focused paradigm to one where financial stability and the reduction of systemic risk has equal prominence.

For regulators, this has thus far meant a widening of perspective to include group oversight and work to create enhanced capital and other prudential standards. Though work is ongoing on the specific contours of these developments, the outlines—as detailed in this paper—have achieved sufficient clarity for effective planning.

From Babylon to Basel:

How and why we got to macroprudential regulation

The history of insurance is inextricably linked to the development of trade and the economic progress of modern man. The development of customs and, later, laws, that allowed for clear contracts and trust among participants enabled the progress of insurance.

The first "written" insurance policies are found in the ancient set of laws called the Code of Hammurabi from about 1772 BCE. This early form of credit insurance, referred to as bottomry, allowed the borrower to use his ship as collateral for his loan for the voyage. What turned a collateralized loan into insurance was a premium included with the loan meant it only had to be paid off if the ship returned safely.

Maritime insurance became more of an investment beginning in the 1200s CE with the creation of maritime insurance policies to cover losses by merchants going through foreign lands, enabling them to share the risk of trade. The insurance itself could be shared among various investors, not just directly linked between voyager and financier. In the 1680s Edward Lloyd opened his famous coffeehouse—and what is considered the modern marine insurance market was born.

Underpinning that market was its own set of regulations—the Lex Mercatoria, or merchant's law—which reflected the needs and customs of merchants and was eventually adopted into British common law.

The current US insurance regulatory system began in the 19th century. In 1837, Massachusetts passed the first set of laws requiring reserves. In 1851, New Hampshire appointed the first commissioner of insurance. In 1871, confusion over differences in state insurance regulation led the New York commissioner to invite his peers to that state. Eighteen states met that year for the first meeting of what became the National Association of Insurance Commissioners (NAIC).[1]

In 1945, the US Congress passed into law the McCarran-Ferguson Act, widely described as reserving to the states responsibility for regulation of the business of insurance. Since then, this Jeffersonian concept of insurance regulation has largely held, evolving in practice in response to various economic changes and sometimes scandal, but underpinned in principle by the unifying concept of insurance regulation as microprudential, focused on the legal entity, and with the primary goal of policyholder protection.

The financial crisis caused some to question the ongoing validity of that premise. The threat to the world economic system led many regulators and legislators to question the adequacy of current regulation. Among them was the International Association of Insurance Supervisors (IAIS), established in 1994 and housed at the NAIC in its early days.

The IAIS, with membership representing approximately 97 percent of the world's insurance premiums, was tasked by the Group of 20 (G-20)'s Financial Stability Board (FSB) with evaluating and mitigating the systemic threat posed by insurers. Victoria Saporta, chair of the executive committee of the IAIS, discussed "*Macroprudential policies for Insurers*" in a speech to the Association of British Insurers Annual Conference in November 2016. Explaining current thinking, Saporta said, "[A] stress-based microprudential capital adequacy framework focused on protecting the soundness of the sector as a whole from macro-stresses and from liquidity mismatches while avoiding excessive balance sheet volatility is a necessary condition to delivering macroprudential stability. But it is not a sufficient condition. Macroprudential overlays are needed to deal with macroprudential risks such as interconnections with systemic counterparties and lack of substitutability."[2]

Despite the objections of many in the industry, including thought leaders at The Geneva Association, it is clear that transnational policymaking organizations such as the FSB consider some insurers to pose a systemic risk, and supervisory standard setters such as the IAIS have been tasked to respond by developing various measures to mitigate this risk.

Broadly speaking, among the measures identified have been increased capital and enhanced prudential requirements, as well as a broader view of what constitutes an insurer and the risk of an insurer—a view more likely to be holistic, examining insurance groups as a whole and attempting to create metrics for comparability across jurisdictions.

The group standards and capital emphasis seem to be more consistent with the recently developed Solvency II regime in some European countries than with the Solvency Modernization Initiative (SMI) of US regulation. That may seem to imply that US-based insurers operating in external markets may have more adjustments to make than their Solvency II counterparts.

It is important to keep in mind the idea of scale here. The IAIS develops the insurance core principles (ICPs) that govern insurance regulation. Supervisory regimes are evaluated by the International Monetary Fund (IMF) during its periodic Financial Sector Assessment Programs (FSAPs) on adherence to the ICPs and thus they affect every insurer and regulator. By contrast, the direct effect of currently developed IAIS measures—except for ICP revisions—is felt by relatively few insurers because the focus is on a few important or internationally active entities.

The highest level of international scrutiny—and concomitant macroprudential measures—is reserved for global systemically important insurers (G-SIIs). A total of 10 have been named worldwide—nine the first year and one the second year (replacing an organization deleted from the list as no longer systemically important)—with only three from the US. The highest level of US scrutiny is for systemically important financial institutions (SIFIs). Only three US insurers have been so designated—the same three that were designated G-SIIs—with one of those designations at least temporarily reversed by the courts. No reinsurers have yet been named G-SIIs or SIFIs.

The next level of heightened standards including the insurance capital standards (ICS) will apply to those insurers deemed to be internationally active insurance groups (IAIGs). There are expected to be about 50 of those worldwide.

So if those affected are so few, why should the vast majority of insurers care? There are some technical reasons. ICPs will both inform and be informed by these changes, for example. But there is another clearer, though less predictable answer.

Water flows downhill. While nothing is ever certain, one could understand insurance supervisors, having agreed that enhanced prudential and capital measures were a positive for the regulation of one subset of insurers, deciding that all insurers should be subject to similar measures. In that sense, the set of measures not now directly affecting some insurers might be considered by those insurers if not a memento mori, a vanitas still life.

There is a possible contrary argument. Proportionality is an important principle in regulation and, as we saw in the banking industry, well-intentioned application of more stringent regulations to all market participants may prompt pushback. As Federal Reserve Board of Governors Chair Janet Yellen said in congressional testimony, "When it comes to bank regulation and supervision, one size does not fit all."[3] She noted the Fed had worked to "identify ways to reduce regulatory burden, particularly for smaller or less complex banks that pose less risk to the US financial system."[4]

Still, recent history is that measures such as the Own Risk and Solvency Assessment (ORSA) and the NAIC's enhanced capital governance models—directly related to the international push for more accurate, contemporary regulation—already affect almost all US insurers.

Even where US insurance regulators are opposed to a regulatory concept, the execution sometimes seems to come close to the spirit of international standards. The NAIC refused to adopt a US group capital standard, for example, but is working diligently on a group capital calculation.

There is a second reason not to assume the US industry will be isolated and insulated from new international regulatory developments. While it is true that, given its size, the US insurance industry can still build a wall and prosper behind it, walls serve as much to contain what is within as to restrain what is without.

To grow, US insurers may need not only to maintain their footholds in the developed markets of Europe, but also to look to developing markets in Asia, Latin America, and Africa. Such expansion may require the building of bridges, not walls, and those bridges may be based in part on acceptance of regulatory measures widely accepted by the international community.

In the next sections, we review the current status of the enhanced prudential measures, followed by a look at the insurance capital standards.

Prudential requirements for insurance companies

Established in 1994 and based at the Bank for International Settlements (BIS) in Basel, Switzerland, the IAIS was called upon to consider SIFIs within the context of the global insurance industry. Together with the FSB, the IAIS determined a subcategory of SIFIs: G-SIIs. Subsequently the IAIS has been working to bring about enhanced supervision of those determined to be G-SIIs.

The 2016 IAIS annual conference focused on risk-based supervision to promote a safe and stable insurance industry, reinforcing the importance of insurance companies—and especially G-SIIs—continuing to monitor and analyze key regulatory developments that may affect their business models and operations.

The building blocks of these enhanced supervisory standards were the existing ICPs as adopted by the IAIS members (currently comprising more than 200 jurisdictions in nearly 140 countries). Guided by FSB recommendations, the IAIS has sought to develop enhanced supervisory measures.

In parallel, the IAIS has been working on a Common Framework (ComFrame) for the Supervision for Internationally Active Insurance Groups. While no determination has yet been made of an insurer's categorization as an IAIG, it is expected that all current G-SIIs will be IAIGs. Measures for IAIGs will also apply under enhanced supervision.

Although the IAIS capital framework is the aspect of the post-crisis regulatory regime for insurers that often receives the most industry attention, G-SIIs should pay equally close attention to regulatory progress on other prudential requirements.

Specifically, in addition to new capital requirements, the IAIS framework of policy measures for G-SIIs[5] sets forth requirements regarding (1) **effective resolution**, including the establishment of Crisis Management Groups (CMGs), the submission of recovery and resolution plans, and the development of institution-specific cross-border cooperation agreements, and (2) **enhanced supervision**, including the development of a Systemic Risk Management Plan (SRMP), enhanced liquidity planning and management, and the ability for the group-wide supervisor to have direct authority over holding companies to ensure that a direct approach to consolidated and group-wide supervision can be applied.

While there currently is no legal framework in place for US regulation of G-SIIs, there have been important developments in both of these areas over the past several years, and additional progress is expected in the near future.

By more fully understanding both of these areas, including the additional work completed at the international level and the implementation of these standards by national authorities, G-SIIs should be able to better position themselves to meet regulatory expectations and minimize potential risks arising from noncompliance or underperformance relative to their peers.

Effective resolution

Following the application of recovery and resolution planning requirements to G-SIIs, the FSB updated its 2011 guidance on *Key Attributes of Effective Resolution Regimes for Financial Institutions* to include a new annex specifying how the guidance should be applied to G-SIIs.[6]

Companies designated as G-SIIs must establish their CMG within six months of this designation, develop a recovery plan within one year, develop a resolution plan based on a resolution strategy and review within the CMG within 18 months, agree to an institution-specific cross-border cooperation agreement within 18 months, and conduct a resolvability assessment within the CMG within two years.[7]

In June 2016, the FSB released final guidance to complement its updated insurance-specific *Key Attributes* guidance. Specifically, it finalized a paper[8] on developing effective resolution strategies and plans for G-SIIs, which is intended to assist authorities in meeting the recovery and resolution planning requirements under the *Key Attributes* and support G-SIIs' CMGs in their resolution-planning work.

The guidance sets forth considerations for determining a *preferred* resolution strategy based on an analysis of insurers' business models, the criticality of insurers' functions, and policyholder protection arrangements. The guidance considers two approaches based on entry into resolution at the level of individual operating entities or at the level of a nonoperating holding company, noting that the preferred resolution

IAIS background

Context

- Established in 1994, located in Basel, Switzerland within the Bank of International Settlements, reports to the Financial Stability Board
- Represents insurance regulators and supervisors of more than 200 jurisdictions in nearly 140 countries
- Coverage constitutes 97 percent of the world's insurance premiums

Mandate

- 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 international standard-setting body for the supervision of the insurance sector, covering both prudential standards and market conduct

Operating model

- IAIS has a small staff and operates through the support of regulators around the world
- It conducts its work through a committee system led by an executive committee, supported by five committees as well as the supervisory forum (subcommittees and working forums can be leveraged by the five committees)
- Participation of US state insurance commissioners has increased dramatically over the past 10 years—it is now very common for US commissioners to travel globally to attend IAIS meetings

Initiatives

- Insurance core principles
  - Led to US SMI developments such as ORSA and governance standards
  - ICPs continue to be rolled out by regulators across the world
- Common Framework for Supervision of Internationally Active Insurance Groups
  - Approximately 55 insurance groups may be designated as IAIGs
- Global systemically important insurers
  - Nine insurers worldwide, three from the United States

Group	Objective	Requirements
Global systemically important insurers	Similar to SIFI designation by the Federal Reserve, targeting regulation around the moral hazard risk of large institutions	Basic Capital Requirement (BCR) Higher Loss Absorbency (HLA)
Internationally active insurance group	Large groups with the goal of establishing a globally comparable consolidated group-wide capital standard and regulatory framework	Insurance capital standard

strategy for an insurance group may be based on either or combine both, depending on the group's characteristics. In addition, the guidance identifies several elements that must be in place so that a resolution strategy can be "feasibly and credibly implemented," including effective cross-border cooperation, information systems, and resources to absorb loss.

G-SIIs and their CMGs should develop a holistic understanding of both pieces of guidance as they enhance their recovery and resolution planning efforts.

Following the FSB guidance, the European Insurance and Occupational Pensions Authority (EIOPA) issued a discussion paper on the potential harmonization of recovery and resolution regimes for insurers.[9] Noting that the "existing fragmented landscape of national recovery and resolution frameworks could cause significant barriers to the resolution of insurers, particularly cross-border groups," EIOPA recommends a minimum degree of harmonization that aims to avoid fragmentation and facilitate cross-border cooperation.

Importantly, however, while EIOPA seeks views on implementing a full suite of resolution powers based on the FSB's *Key Attributes* across all European Union jurisdictions, it stopped short of fully supporting this view given the lack of an EU-wide consensus on the need for such powers. It remains unclear how EIOPA will proceed, but the discussion paper may imply that the implementation of a harmonized resolution regime is not imminent.

For HLA and BCR purposes, the IAIS defines qualifying capital resources as either Core or Additional.

- The G-SII's Core capital is comprised of qualifying financial instruments and capital elements other than financial instruments that contribute to financial strength, absorb losses both on a going-concern and winding-up basis and otherwise contribute to survival through periods when the G-SII is under stress.
- The G-SII's Additional capital is comprised of qualifying financial instruments and capital elements other than financial instruments that protect policyholders in winding up. The key characteristics of capital instruments that qualify as Additional capital are subordination and availability to absorb losses in winding-up.

Enhanced supervision

In addition to requirements with respect to recovery and resolution planning, G-SIIs are subject to heightened group-wide supervision, including the development of an SRMP and the development of liquidity management and planning requirements within one year of designation.

In December 2013, the IAIS issued guidance[10] to group-wide supervisors on how they would direct applicable G-SIIs to develop SRMPs. Notably, the guidance states that an SRMP should include:

1. A reference to its liquidity management planning in order to explain how the G-SII intends to manage potential higher liquidity risks;
2. A reference to its recovery plan and an explanation of how that plan would mitigate the systemic risks in a potential recovery situation;
3. An outline of its intra-group financial transactions with respect to its effects on the overall risk and risk distribution;
4. A description of linkages to other measures related to the plans to manage, mitigate, or reduce systemic risk; and
5. A brief explanation of the recovery triggers that require reassessment of recovery plans.

The IAIS guidance also stipulates that if a G-SII opts to expand any of its systemically risky activities, it must explain how these activities are managed to address their potential for an increased systemic impact on the financial system. Conversely, if a G-SII opts to discontinue or reduce any of its systemically risky activities, it is required to submit an outline of the planned timeline for such actions.

Although the SRMPs for the originally designated G-SIIs were required to be completed in July 2014, the IAIS continues to assess the implementation of the SRMP.

G-SIIs should continue to refine their SRMPs by considering new guidance from the IAIS, as well as leading practices across the industry.

What should covered organizations do?

As the IAIS, FSB, and national authorities continue to supplement existing guidance regarding prudential requirements for G-SIIs—specifically with respect to recovery and resolution planning and enhanced supervision—covered organizations should develop a holistic understanding of the requirements in order to more effectively prepare for compliance and meet regulatory expectations.

In addition, all IAIGs should pay close attention to the FSB's G-SII list, the next update to which is due in November 2017. In 2015, the FSB added one insurance company to the list while removing another company.[11] Although this move represented the first change to the G-SII population since the FSB published its inaugural list in 2013, it demonstrated that the IAIS and FSB continue to evaluate IAIGs annually, and it is possible to be removed from the list after being previously designated.

By understanding the IAIS and FSB's methodology for categorizing certain insurance companies as systemically important, IAIGs should be better prepared to tailor their business models to activities that are not seen as systemically risky.

Insurance capital standards

Through the G-20, the economic and fiscal governors of the world's major economies are looking to develop a global capital standard for organizations determined to be SIFIs. Following the financial downturn, in 2008 the G-20 tasked the FSB with the development of a package of regulatory reforms specifically focused on SIFIs.

The FSB's framework for reducing risk to the global financial system includes recommendations for a number of policies, which combined, are intended to enhance the level of supervision of SIFIs, including:

1. A more intensive and coordinated supervisory approach;
2. Improved mechanisms for the resolution limiting the impact on financial system stability and risk to the taxpayer;
3. A requirement for Higher Loss Absorbency (HLA) capacity for SIFIs, reflecting the perceived greater risks that these companies pose to the financial system; and
4. Other supplementary requirements determined by national authorities.

The IAIS has set out its proposals for enhanced supervision and has been working with its members to develop these, including:

1. G-SII determination/methodology and criteria;
2. Development of regulatory colleges and coordination mechanisms for supervisors; and
3. HLA capacity with a specific focus on insurance activities determined to be non-traditional where it is perceived there is a greater risk of financial stability system impacts. IAIS seeks to reduce the likelihood of failure or improve the ability for such events to be absorbed.

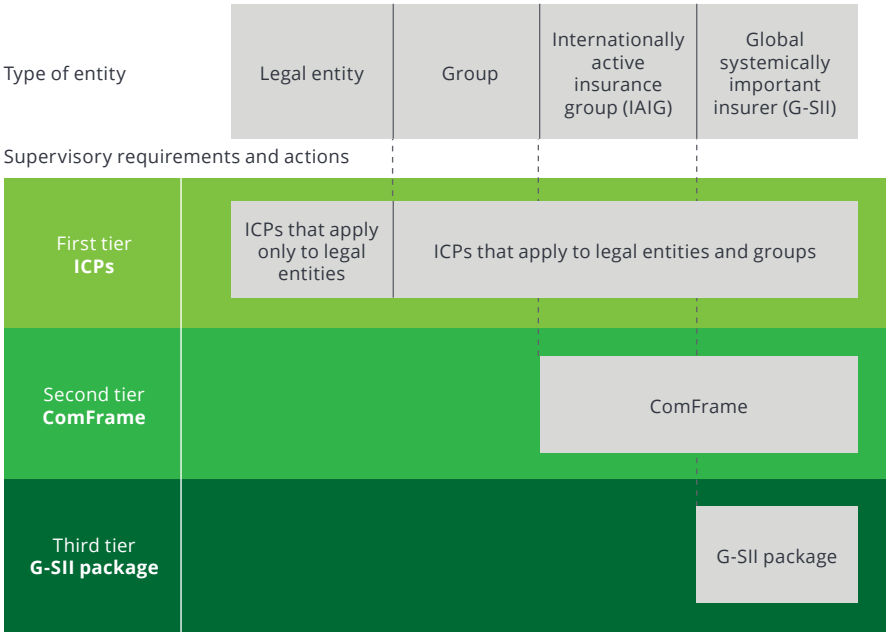
A key challenge for the IAIS at the outset was that there was no global capital standard that was consistent in its approach for the insurance sector. Without this, it was determined that it was difficult to build certain aspects of enhanced supervision, such as the HLA. In November 2011, the IAIS decided to leverage the work being done in ComFrame to develop a global capital standard.

Global capital standard development

In July 2013, the FSB published its listing of the identified G-SIIs and the measures that applied to them. This included the rapid development of a Backstop Capital Requirement—later renamed the Basic Capital Requirement (BCR)—and the development of a supervisory framework and capital standard for IAIGs. In response, in October 2013 the IAIS announced its plan to develop a risk-based global ICS.

The IAIS has launched a number of consultation documents and rounds of "field testing" to develop the new global capital standards. In the short-term, the BCR along with an HLA uplift will apply to G-SIIs only and this has been subject to private filing/submission through the field testing process. Ultimately the BCR will cease to exist and be replaced by the more risk-based ICS. Version 1.0 of the ICS for confidential reporting purposes is due to be agreed in London in June 2017.

Architecture of IAIS international supervisory requirements



Source: International Association of Insurance Supervisors

Developing a global capital standard is a complex process and clearly one that has taken a great deal of interest from the insurance industry and wider stakeholders.

BCR

Finalized in October 2014 by the IAIS and subsequently endorsed by both the FSB and the G-20, the BCR is the first global capital standard for G-SIIs applying to all group insurance and noninsurance activities. As a factor-based approach, the BCR itself is seen as a foundation level of capital onto which the HLA component will be added.

The HLA capital component is derived from the assessment of the G-SII itself, which, given its business mix, is determined to fall into one of three buckets: low, mid, or high. That determination drives what factors are applied to the exposures within the BCR allowing, albeit crude, a risk-based approach to capital for G-SIIs.

The average uplifted BCR for G-SIIs sought to approximately match the Prescribed Capital Requirement (PCR). The BCR and HLA components under the IAIS timelines will apply to G-SIIs from 2019 on, when they will be expected to hold no less than the total required capital (BCR+HLA).

Next step: ICS

Given its lack of sophistication and lack of a developed risk-based approach, the BCR was always set out to be an interim solution as a capital standard for G-SIIs. The ICS is seen as a more sophisticated capital standard. The first consultation document on the ICS was issued by the IAIS in December 2014. Following the consultation period and collective insights gained through field testing exercises, a second round of consultation was held in July 2016.

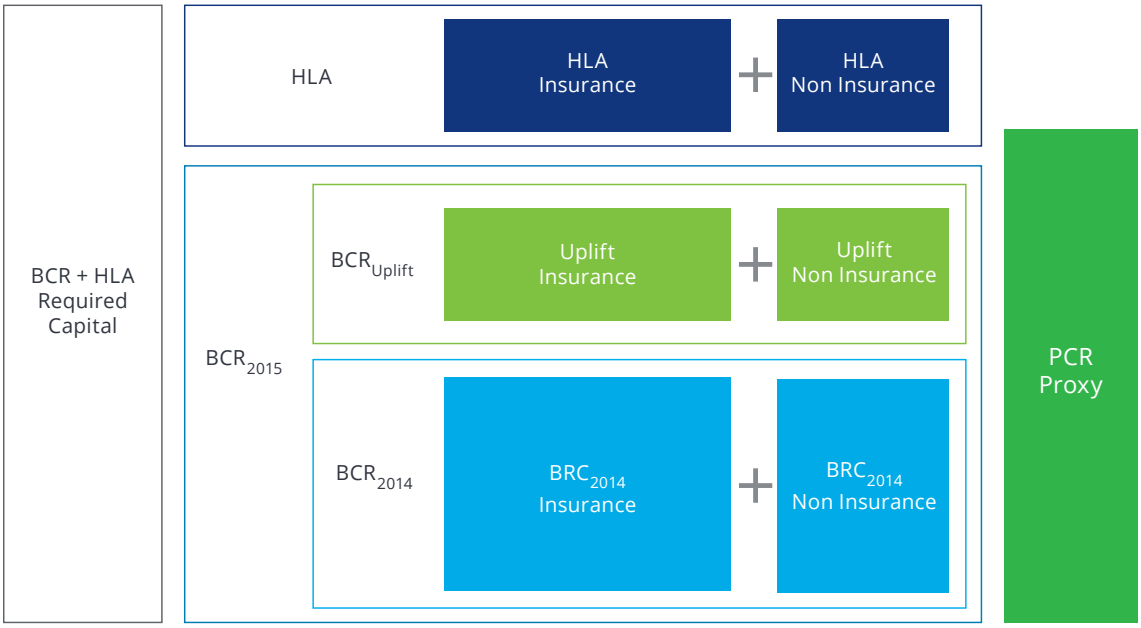
To date, the ICS has been subject to two rounds of field testing, one in 2015 and the second in 2016. The IAIS plans to replace the BCR with the ICS. Following the approval of ICS 1.0, work on ICS version 2.0 will commence. The ICS will apply to both G-SIIs and IAIGs and is part of a package of measures being developed under ComFrame, which also includes governance and enterprisewide risk management requirements. The ICS will represent the group PCR per ICP 17.4, a solvency control level above which the supervisor does not intervene on capital adequacy grounds.[12]

The ICS can be broken down into three primary components:

1. A valuation component of which two methods are being considered:
   A. Market Adjusted Valuation (MAV); and
   B. Generally Accepted Accounting Principles with adjustments (GAAP+) method
2. Capital resources; and
3. The capital requirement.

Basic Capital Requirements

BCR, BCR uplift, and HLA components (not to scale)



Source: International Association of Insurance Supervisors, *IAIS BCR+HLA Fact Sheet 5 October 2015*, 2015.

ICS principles

ICS Principle 1

The ICS is a consolidated group-wide standard with a globally comparable risk-based measure of capital adequacy for IAIGs and G-SIIs.

ICS Principle 2

The main objectives of the ICS are protection of policyholders and to contribute to financial stability.

ICS Principle 3

One of the purposes of the ICS is the foundation for HLA for G-SIIs.

ICS Principle 4

The ICS reflects all material risks to which an IAIG is exposed.

ICS Principle 5

The ICS aims at comparability of outcomes across jurisdictions and therefore provides increased mutual understanding and greater confidence in cross-border analysis of IAIGs among group-wide and host supervisors.

ICS Principle 6

The ICS promotes sound risk management by IAIGs and G-SIIs.

ICS Principle 7

The ICS promotes prudentially sound behavior while minimizing inappropriate procyclical behavior by supervisors and IAIGs.

ICS Principle 8

The ICS strikes an appropriate balance between risk sensitivity and simplicity.

ICS Principle 9

The ICS is transparent, particularly with regard to the disclosure of final results.

ICS Principle 10

The capital requirement in the ICS is based on appropriate target criteria, which underlie the calibration.

Source: International Association of Insurance Supervisors, *ICS Goals, Principles and Delivery Schedule*, 2016.

Of particular importance in determining the ICS are:

1. The scope of the group to which the calculation applies;
2. The discount rate applied to the valuation;
3. What capital resources are considered eligible; and
4. The stresses applied to the risks that make up the capital requirement.

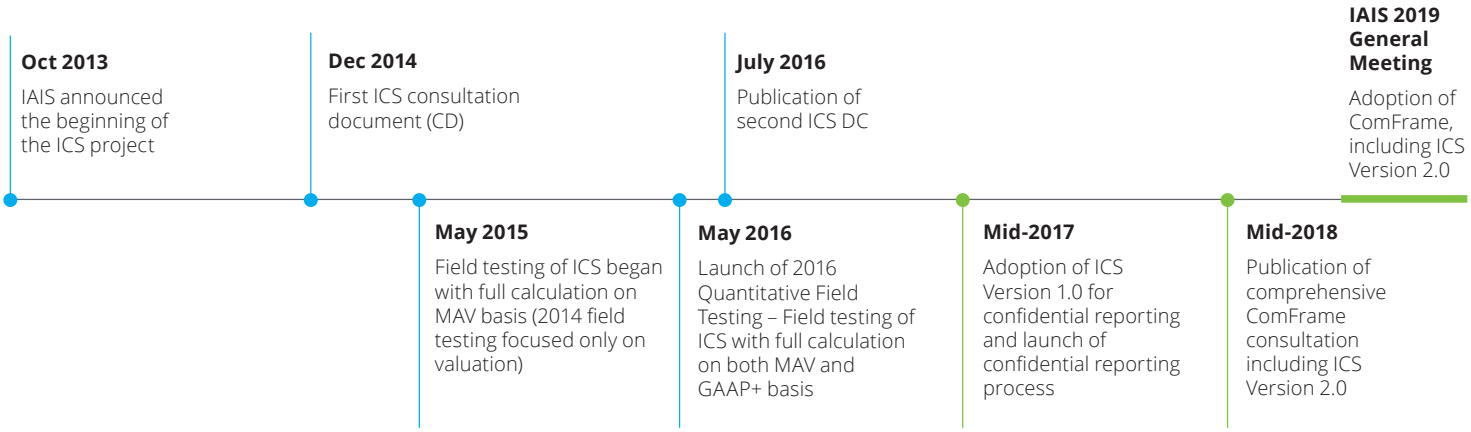
There are many questions yet to be answered in the development of a global capital standard. In fact, the recent consultation document lists many of the primary unanswered questions, such as:

- The potential use of internal models in version 2.0;
- How the ICS will be used by supervisors;
- The transitional arrangements for implementation of the ICS;
- How the key goal of comparability of ICS submissions will be achieved when discretion and judgment remain;
- Whether the ICS will be included in the IMF's FSAP;
- The interaction of local entity capital requirements and the ICS, as well as whether local arrangements could be considered consistent;
- How the ICS will impact enterprise risk management practiced by insurers; and
- The practical operationalization of the ICS within an insurer's processes.

In addition, for US insurance companies the issue is further complicated by both the Federal Reserve Board and the NAIC working on their own versions of a group capital standard. One thing seems certain at this stage: the US is expected to see the emergence of its first insurance group capital calculation, the application and impact of which remain unclear.

As with Solvency II, a number of questions remain challenging. This includes how to address the issue of procyclicality while not driving inappropriate behavior through the cycle under a market consistent approach.

ICS and ComFrame timeline



Source: International Association of Insurance Supervisors, *ICS Goals, Principles and Delivery Schedule*, 2016.

Looking ahead

While the elements of the enhanced prudential and capital regimes may change, the basic structure of the new supervisory regime is beginning to become clear. For large insurers, especially G-SIIs or potential IAIGs, this should mean an enhanced focus on and engagement with supervisors at both the international and national levels.

In the US, the NAIC has always welcomed industry involvement, and—after what might be considered some missteps—the IAIS has declared an openness to stakeholder involvement. Such engagement on industry's part would be consistent with a holistic approach to managing regulatory change.

Such an approach could seek to achieve enterprisewide coordination across core regulatory change activities. This would include creating a coordinated response for foreseeable regulations and utilizing scenario planning techniques for the unknowns, empowering rapid response teams, and embedding a modus operandi in organizations that would translate regulatory analysis into actionable plans.

While G-SIIs and IAIGs may be on the front lines of this engagement, smaller, locally supervised insurers should not consider themselves immune from the effects of these planned changes or from the need to plan their responses.

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