Global Insurance Supervision Is Changing

Monitor and Prepare

By Sheetal Kaura and Kenneth McIvor

Internationally, insurance regulators are advancing plans that will layer additional standards of supervision to new classes of insurers, prompting management to assess their current operating and reporting standards against the potential future requirements asked of their business.

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This spring, insurance regulators around the globe came together with insurance industry leaders to advance major proposals that aim to create global safeguards that supplement existing local regulations. These proposals will have implications for the larger players in the insurance market, but the finer details have yet to be agreed upon. Developments to date show that those crafting these proposals have been responsive to industry feedback, although several areas of concern still exist.

These key proposals from the International Association of Insurance Supervisors (IAIS) are targeted at group supervision and financial stability.

The IAIS Insurance Core Principles (ICPs) underpin these developments and are relevant to all insurers and insurance groups, regardless of their size or the risk they present to the wider market. The ICPs seek to encourage convergence toward a globally consistent supervisory framework, and provide criteria to facilitate comprehensive and consistent assessments. Regulators of insurance markets around the world are looking to the ICPs to help them create regulatory frameworks that limit the inconsistencies across jurisdictions.

The latest IAIS efforts impact two categories of insurer:

- *Internationally active insurance group (IAIG)* is the designation to be given to insurance groups or financial conglomerates that exceed thresholds on size and international activity. These entities will fall under the remit of the Common Framework (ComFrame), a regulatory framework proposal developed by the IAIS.
- *Global systemically important insurer (G-SII)* is a designation that will be conferred by the Financial Stability Board (FSB), an international body of financial authorities and regulators that is consulting with the IAIS to identify "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." G-SIIs are expected to be subject to policy measures that would enhance supervision, encourage effective resolution and ensure an elevated capacity to absorb losses.

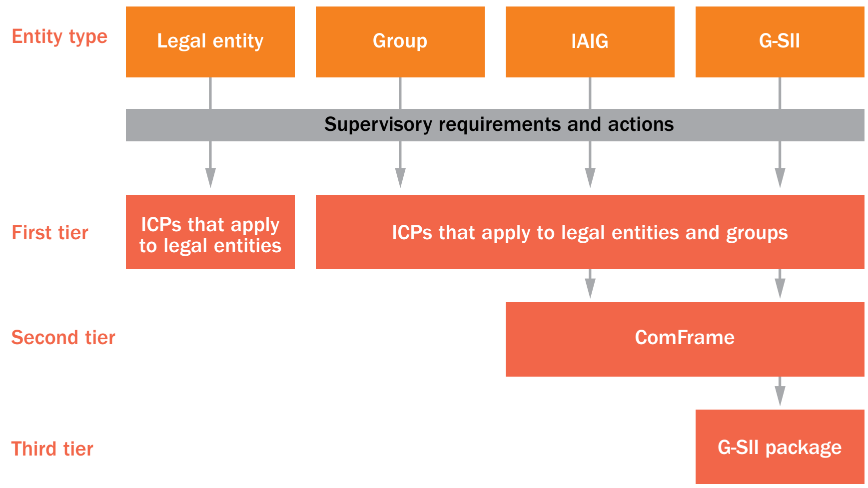
The latest thinking on ComFrame considers G-SIIs as a set of insurers within the set of IAIGs. *Figure 1* shows the relationship between the ICPs, ComFrame and G-SII proposals.

IAIGs and ComFrame

The IAIS formally introduced the concept of ComFrame for the supervision of IAIGs in an effort to put IAIGs on similar footing. Its adoption is intended to respond to the increasing globalization of the sector and incorporate the lessons learned from the financial crisis.

Both large insurance groups and home supervisors could benefit from this new structure, but there is a risk that added burdens might result in IAIGs becoming less competitive. Several large insurance groups now operate in multiple jurisdictions without a single global framework to supervise them effectively, and home supervisors are left without much clarity about how these insurance groups manage their risks. These groups might include noninsurance entities that contribute to the overall risk of the enterprise.

Figure 1. The architecture of IAIS activities



As of the last working draft, released in July 2012, there are four modules to ComFrame:

- **Scope of ComFrame:** Provides criteria to identify IAIGs and the roles of supervisors
- **IAIG:** Examines IAIG governance, enterprise risk management (ERM), structure and strategy requirements, valuation and capital standards, and reporting and disclosure obligations
- **Supervisor:** Identifies and describes the group supervision process, and supervisor cooperation and coordination, including management and resolution of IAIGs through crisis
- **Implementation:** Outlines jurisdictional requirements to implement the framework

ComFrame was first introduced as a concept paper in July 2011, marking the end of the first year in a planned three-year development phase. The expectation is that in the third quarter of 2013, another draft of ComFrame will be issued for public consultation, and by the beginning of 2014, ComFrame will be ready for the calibration phase, in which quantitative requirements will be determined following impact assessments.

The IAIS has indicated it plans to adhere to this timeline despite the fact that its 2013 working draft is not the final integrated version expected for calibration. A field-testing task force was created in 2013, charged with the task of leading different phases of implementation of ComFrame requirements within IAIGs. Throughout this calibration phase, continuous dialogue with potential IAIGs and IAIS observers is expected, which will help shape the final ComFrame draft.

In our last *Insights* covering the ComFrame developments, our perspective on the draft was that it appeared overly prescriptive and could inhibit the management and competitiveness of IAIGs. It is expected that the next public draft will incorporate more flexibility in the necessary structure of IAIGs.

Group Capital Assessment

ComFrame capital assessments will be cause for serious consideration among candidate IAIGs. Previous drafts of ComFrame prescribed a capital requirement at the group level, which could undermine the different capital requirements in various jurisdictions. For example, the developing Solvency II European regulatory framework groups internal models under Pillar 1, which establishes quantitative requirements such as the amount of capital an insurer should hold, and alternative measures of solvency under Pillar 2, which addresses the governance, risk management and supervision of insurers. In the U.S., a risk-based capital formula is used, and economic capital models support internal management decisions and rating agency assessments.

The IAIS is still exploring the feasibility of a group capital requirement, but currently, the focus is on the use of stress tests as a means to assess capital adequacy at the group level. However, without a widely accepted global valuation standard, any group capital requirement will be met with many implementation challenges. Initially, an International Financial Reporting Standards global accounting standard was to be used as a starting point for ComFrame, but international accounting convergence cannot be ensured. As an alternative, the ComFrame Adjusted Balance Sheet (CABS) has been proposed to promote comparability across IAIGs. Adjustments may be made to account for jurisdictional differences and off-balance-sheet items in order to derive the group consolidated balance sheet. The CABS is a compromise to capital requirements being imposed at the IAIG level, which has been much contested. There will be additional effort and reporting requirements to derive the CABS. Emphasis will be placed on determining adjustments in a consistent manner, but to the extent that the CABS deviates from the insurer's own valuation, there will be a disconnect between the assessment of risk and capital under ComFrame and management's view.

Sheetal Kaura
Specializes in life insurance risk consulting and software.
Towers Watson, Chicago

Kenneth McIvor
Specializes in life insurance risk consulting and software.
Towers Watson, London

Internal Frameworks

The most recent draft of ComFrame acknowledges that IAIGs will not all have centralized risk management functions at the group level. Instead, the focus is on the increased transparency required in order to understand the ERM framework, group governance structure and policies, and the internal audit function. This increased transparency will result in increased disclosures and more onerous reporting requirements. This also causes confidentiality concerns where certain jurisdictions are not required to legally comply with the same confidentiality provisions as other jurisdictions.

Global Supervision

We believe there is a need for a common framework for group supervision, and the development of global supervisory standards is a positive step forward. Supervisory colleges will play important roles in global supervision, creating a more transparent relationship between host and group supervisors, and the IAIG.

The criteria used to identify IAIGs are critical because they will be key to determining whether a group is subject to the ComFrame requirements. The current proposal identifies an IAIG as an entity operating in three or more jurisdictions, with over $50 billion in total assets and over $10 billion in total gross written premiums. But the use of a size-based criterion instead of one based on materiality of risk might group certain companies as IAIGs even though they might contribute very little to the overall risk of the local insurance market or have minor activities in one of the three jurisdictions. There might also be a group with material risk exposure in two jurisdictions that would not be subject to ComFrame because of the three-jurisdiction requirement in the proposals. The IAIS has indicated it expects about 50 insurers to be named IAIGs. Some of these IAIGs are likely to be G-SIIs as well.

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G-SIIs and Financial Stability

The financial stability framework being devised for G-SIIs has grown out of the need to protect the economy from the impact of distress or failure of insurers that deviate from the traditional insurance business model. One of the key issues in the financial stability debate surrounds the definition and measures applying to nontraditional, noninsurance (NTNI) activities. A concern of the industry is the potential for long-standing insurance activities or alternatives to conventional insurance products that present no systemic risk to be subject to the enhanced measures that NTNI business will face.

It is envisaged that the additional capital requirement for higher loss absorption (HLA) capacity will be tied to the level of capital held against the NTNI activities undertaken by the firm. However, ascertaining a consistent and comparable measure of the capital with respect to this business is not trivial. The IAIS proposes that the ICPs and the Basel III capital standards (for noninsurance activities) from the banking sector be the basis for capital with respect to the NTNI business.

Insurers identified as G-SIIs could face significant requirements, such as being tasked with separating traditional blocks of business (assets and liabilities) from NTNI business as part of a systemic risk reduction plan (SRRP). Such separation is intended to limit the contagion impact of the NTNI activities on the rest of the business. The SRRP could also prohibit a G-SII from engaging in activities that are deemed systemically important.

Preparation of a recovery and resolution plan (RRP), which has also been introduced for IAIGs, is another part of the G-SII proposals. The RRP assesses and documents recovery options, enabling them to be mobilized quickly and effectively when necessary, and supplies the regulator with the information and analysis it needs to formulate a resolution plan for the firm. Originally a requirement of banking institutions following the financial crisis, RRPs are proposed for systemically relevant insurers, and outside of the G-SII debate, it is being considered whether their application is more widely relevant to insurers.

Under the currently proposed NTNI classification, alternative risk transfer techniques such as insurance-linked securities would be classified as nontraditional and collateralized debt obligations, and credit default swaps would constitute possible examples of noninsurance activities.

The NTNI classification might include one of the insurance industry's important retirement products, variable annuities (VAs), regardless of the product features or underlying asset and liability management strategy. The VA product, which combines the potential for income growth and various guarantees, is a relatively new and innovative means for providing income in retirement. By putting VAs under the NTNI category, an insurer is more likely to receive the G-SII designation due to its VA business and consequently face more stringent capital requirements on its NTNI activities. This could discourage the distribution of VAs and detract from innovation in an important area of the financial market.

Overall, the goal of the G-SII work is to increase both public and policyholder protection by reducing moral hazards and negative impacts on the market should a G-SII fail. Early in the debate, the IAIS investigated and concluded that there is little evidence that traditional insurance generates or amplifies risk within the financial system or real economy, and it is deviations from the traditional business model that need to be supervised more closely. The delivery of protections through enhanced supervision, effective resolution and HLA capacity will make it necessary for insurers to prepare early and be ready for closer regulatory scrutiny in some specific areas of business.

Prepare Now

Global insurers are on the cusp of major regulatory change, and yet many insurers still have misgivings about critical issues within the proposals that will profoundly impact their businesses and could have unintended consequences. G-SIIs face prescriptive new requirements, such as the possible NTNI classification of some of their businesses, potentially including important product lines such as VAs. IAIGs might need to comply with onerous requirements that could make them less competitive, potentially offsetting some of the benefits of increased regulatory consistency.

Figure 2. Planned timelines for ComFrame and financial stability proposals

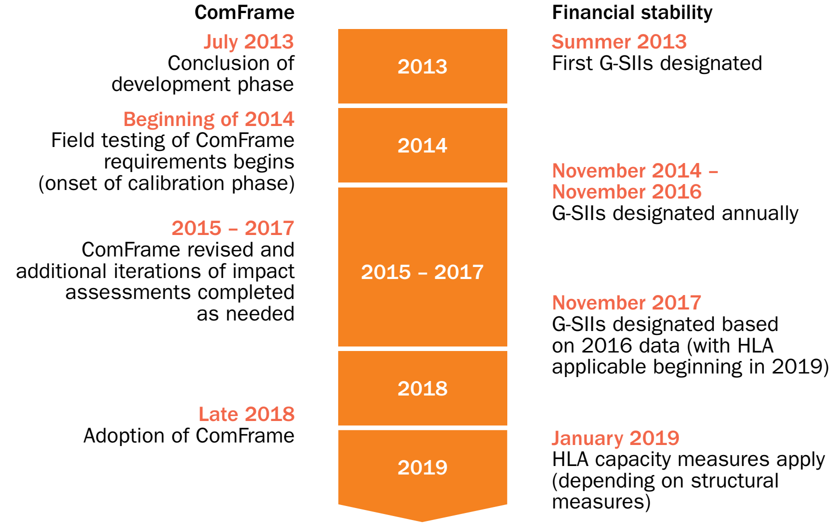

Figure 2 shows the proposed timeline for the developments expected under the ComFrame and financial stability plans. As development gives way to implementation, many insurers will need to monitor the progress of the plans and assess their readiness while also considering where efforts need to be targeted to achieve compliance.

For comments or questions, call or e-mail Sheetal Kaura at +1 312 201 5289, sheetal.kaura@towerswatson.com; or Kenneth McIvor at +44 20 7170 2529, kenneth.mcivor@towerswatson.com.