Insurance regulation – On the move
Anchoring regulatory change

Domestic and international regulatory frameworks

The International Association of Insurance Supervisors (IAIS) has recently concluded its wholesale review of insurance core principles (ICPs), which provides standards and guidance to regulators on matters such as authorization, solvency, Enterprise Risk Management (ERM), valuation, governance, conduct, and group supervisory requirements. Based in Basel, Switzerland, and established in 1994, the IAIS is made up of insurance regulators and supervisors of approximately 190 members (the United States has 50 members) representing 140 countries. Its primary goals are to contribute to global financial stability and to promote globally consistent supervisory standards. Individual jurisdictions are then expected to implement the ICPs developed by the IAIS for the protection of policyholders in their home markets.

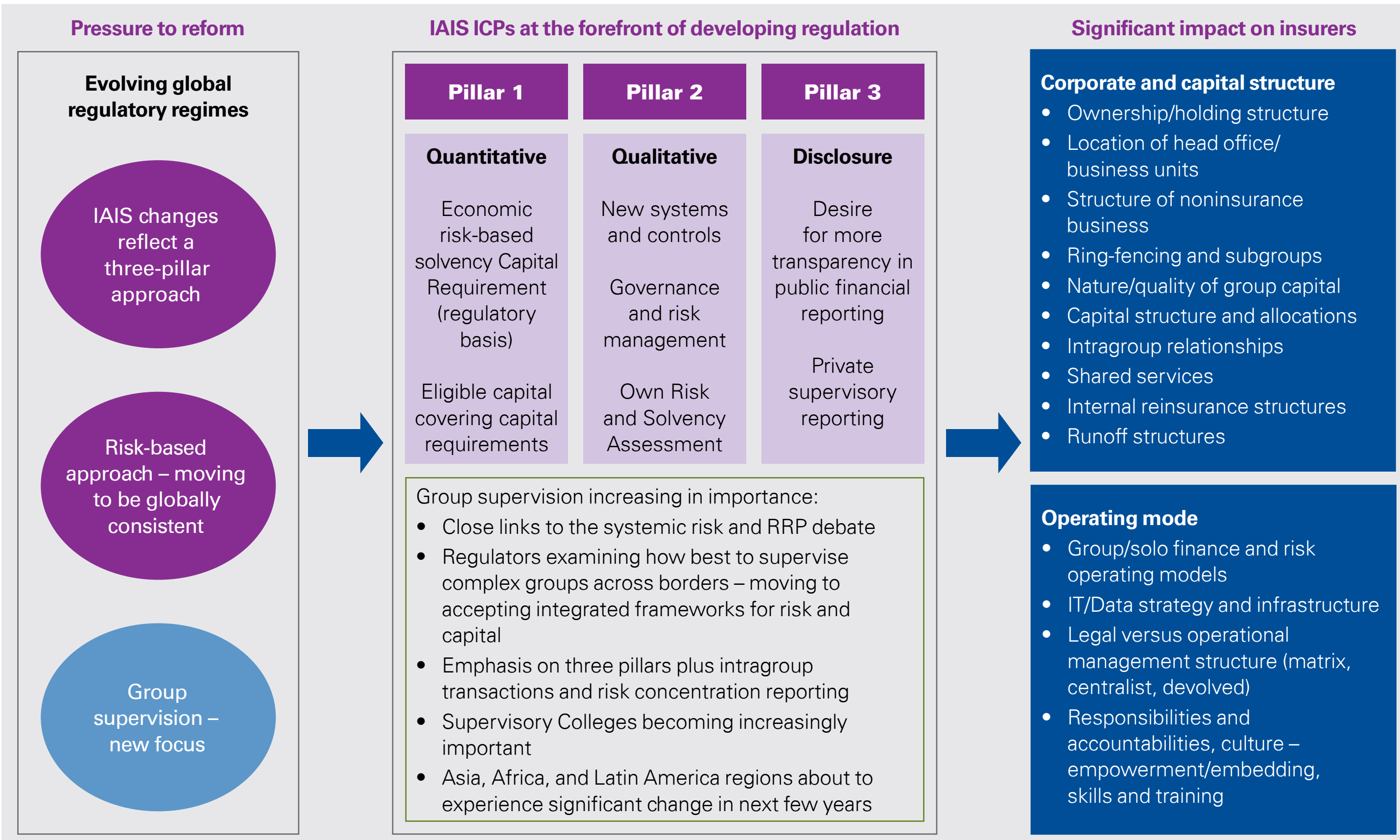
The revised ICPs were completed in October 2011 and represent a fundamental overhaul of the supervisory framework. With a three-year transitional provision for implementation, many jurisdictions will have to work hard to review and assess how they will implement collectively over 400 pages of requirements and guidance. Implementation is monitored through the International Monetary Fund (IMF) under its Financial Sector Assessment Program (FSAP).

The IAIS reforms contain a number of significant milestones, namely:

- Encouraging all jurisdictions to move toward implementing risk-based frameworks
- Recommending that regulators specify in their solvency framework the minimum level of policyholder protection being afforded
- Formally setting out regulatory intervention levels that are linked to regulatory capital requirement levels
- Advocating the use of a total balance sheet approach to the measurement of an insurer's risks and consistency in the measurement of assets and liabilities
- Introducting of ERM requirements and encouraging new analysis tools such as stress and scenario, including reverse stress testing
- A requirement for all regulators to seek from regulated firms an Own Risk and Solvency Assessment (ORSA).

Interestingly, the IAIS reforms mirror closely that adopted by the Basel Committee for Banking Supervision (BCBS) in the supervision of banks by introducing, in effect, a three-pillar approach which the majority of insurance supervisors globally are now adopting.

Emerging insurance reform using the three-pillar approach:



International supervisors now have the task of implementing the ICPs. In Europe, Solvency II proposes to adopt a very similar framework and similar changes are now occurring or planned in many other markets, such as Bermuda, Singapore, and South Africa. The implementation of the ICPs is a clear example of where international policy flows down into domestic insurance requirements. This is nowhere better evidenced than in the United States and the recent adoption by the National Association of Insurance Commissioners (NAIC) of the ORSA model law. This, coupled with the Model Holding Company law, provides the U.S. insurance industry with the tools to perform more group-wide assessments of diversified financial services companies and their associated risks rather than the more traditional examination of the solo insurance entities.

The U.S. ORSA requirements will mean a very different type of regulatory filing to that which U.S. insurers are familiar with. The ORSA filing will be a group summary and will follow a free-form text principles-based requirement rather than specific rules. The ORSA report falls into three broad headings: a summary of the group's enterprise risk framework, a summary of the quantitative and qualitative measures, and a forward-looking projection of solvency needs. A key challenge is that while many firms may have component parts of the ORSA requirements, many firms will struggle with the enterprise/group consolidation of the ORSA requirements.

Beyond the ICPs, the IAIS is now moving forward with its proposals for a Common Framework for the supervision of internationally active insurance groups (IAIGs)—known as "ComFrame."

The ComFrame proposals focus on four key areas:

- *Module 1 – The Scope of ComFrame – identification and the process for identification of IAIGs; the scope of supervision stemming from ComFrame and the identification of the groupwide supervisor*
- *Module 2 – The IAIG – governance requirements and enterprise-wide risk management; strategy and intragroup transactions/exposures; liabilities, exposures, provisions, and assets/investments; reporting and disclosure*
- *Module 3 – The Supervisors – the supervisory and group supervisory process, colleges, and supervisory coordination; crisis management and IAIG resolution*
- *Module 4 – Implementation of ComFrame – application of ComFrame, peer review, compliance data, macro prudential surveillance*

The framework won't be further developed until next July, which at this point, the IAIS expects to commence the next phase of ComFrame by undertaking a formal calibration stage. Calibration will involve the possibility of building a common approach to insurer solvency requirements, providing for further refinement and adjustment of supervisory frameworks.

It is important for both domestic and international insurers and regulators to join the international debate and take the opportunity during periods of consultation to put forward their perspective. Supervisory standards are often formulated many years in advance of an agreed international position which then invariably involves implementation by local supervisors at the domestic level. The impact of this implementation can sometimes then come as a surprise to many stakeholders. For example, the IAIS ICPs will introduce substantial changes for many markets, which is likely to be challenging for both insurers and supervisors alike such as the introduction of risk-based capital requirements and greater ERM, data, and public disclosure requirements.

Similarly, the current discussion at the G20 and Financial Stability Board (FSB) concerning systemic risk in the financial services sector is another good example where international engagement is critical to ensure final implementation at the domestic level is appropriate and proportionate to the needs of local policyholders. This is particularly relevant for the insurance industry given different stakeholders hold different perspectives on whether insurers are even systemically relevant.

Essentially there are two separate but interlinked elements when examining systemic risk for the insurance sector—the continuity of critical economic functions and the resolvability of an insurance group in an orderly manner. The latter has particular resonance for the U.S. market given systemic importance is often viewed as a local state issue in terms of policyholder protection combined with the absence of a formal groupwide supervisory framework. Other important considerations such as minimizing the recourse to government funds in the event of failure, associated impacts on the local economy, and political considerations are also relevant and understandable factors requiring examination. Globally, there is no consistent view on how such maters should be treated with different markets adopting different approaches, as evidenced in the banking sector. The IAIS is currently working towards articulating a common approach for developing a supervisory framework for potentially Systemically Important Insurance Institutions (SIIIs).

The international versus local debate is also relevant when examining issues such as resolution and continuity as often implementation can only be effected locally in the insurance sector given the legal entity focus of the typical insurance group operating model, as used in the United States, where subsidiaries rather than branches are created by insurance groups, requiring solo capital and funding considerations. In addition, resolution laws generally differ between jurisdictions

internationally and can impact an insurance group's recovery and resolution planning. The need to understand "local" regulatory powers is important to recognize before "resolvability" can be properly assessed. Considerable uncertainty can exist for an insurance group regarding cross-border operations given unilateral actions that could be taken by local supervisors in the event of crisis situations, especially where the need to protect local policyholders becomes an overriding imperative for the immediate regulatory authority concerned.

It is therefore likely that cross-border cooperation and implementation concerning systemic risk analysis would benefit from better facilitated group supervision. In this regard, further action may be required from the NAIC to enhance its current oversight of groupwide risks. The role of the newly created Federal Insurance Office (FIO) will also be of importance, particularly in regards to assisting US supervisors with international cooperation and oversight matters.

At a more immediate and practical level, there are also a number of enhancements that could be made to the existing supervisory framework concerning systemic risk analysis such as ensuring better linkages between risk appetite and strategy setting and a greater focus on noncore insurance activities and off-balance sheet items. For example, the impact on the financial condition of an insurer arising from special purpose vehicles, hedge funds, derivatives, private equity, structured credit products, insurance linked instruments, hybrid instruments that embed derivatives, and dynamic hedging programs should be assessed and reported to determine any systemic relevance.

In this regard, the introduction of Recovery and Resolution Plans (RRPs), focusing on "recovery" vis-à-vis "resolution" for the insurance sector is likely to be a worthwhile initiative provided due consideration of the insurance specificities which exist vis-à-vis banking is taken into account. A case remains for more innovative solutions and tailored measures to be applied to the insurance sector when examining appropriate financial stability policy options. For example, the use of reverse stress testing, or test-to-destruction analyses, which identify scenarios that are most likely to cause an insurer to fail, should also more fully form part of the ORSA requirements. The benefit of requiring such analysis is that it can provide management, and supervisors, the necessary information to assess the adequateness of the management actions proposed in order to avoid business failure. This leads to an element of specific focus, that of resolvability and associated planning. Insurance failures are typically resolvable through an orderly run-off, but exceptions to this have occurred and remain plausible such that there may be a case for putting in place ex ante arrangements to ensure an orderly conclusion to various scenarios.

RRPs are yet another example of the international focus currently being given to financial stability issues and serves as an indication of likely implementation by overseas supervisory jurisdictions. Engagement in these international debates is therefore vital for U.S. firms to ensure a proportionate and effective framework is then applied by home supervisors.

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