Systemically Important Insurers – FSB Designations

Executive Summary

The Financial Stability Board (FSB), in consultation with the International Association of Insurance Supervisors (IAIS) and national authorities, has announced the initial list of global systemically important insurers (G-SIIs). The assessment methodology for constructing this list, along with a set of policy measures that will apply to the G-SIIs, was finalized and published by the IAIS on July 18, 2013 and endorsed by the FSB. Nine insurers - three from the United States, five from Europe, and one in China - were named. As with global systemically important banks (G-SIBs) previously identified by the FSB (of which there are currently 28), the list of G-SIIs will be reviewed and updated on an annual basis. The FSB, along with the IAIS and national authorities, will consider designation of major reinsurers in July of 2014.

Insurers designated as a G-SII will be subject to:

- Enhanced group-wide supervision;
- Recovery and resolution planning requirements; and
- Higher loss absorbency requirements.

Enhanced supervision is expected to begin immediately. The recovery and resolution planning requirements will be phased-in between July and December of 2014. The IAIS will develop "backstop capital requirements" to apply to all group activities by November 2014 and to complete final higher-loss absorbency requirements by year-end 2015 that would apply to G-SIIs beginning January 2019.

Background

The FSB released a "*Report on Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*" that was endorsed by the G-20 in November 2010. The following November, the FSB published an integrated set of policy measures "to address the systemic and moral hazard risks associated with SIFIs" and designated an initial group of G-SIBs using a methodology developed by the Basel Committee on Banking Supervision (Basel Committee). At that time, the G-20 leaders requested the IAIS pursue work to develop a Common Framework for the Supervision of Internationally Active Insurance Groups (commonly called ComFrame) by 2013 and to complete an assessment methodology for identifying G-SIIs. The FSB states that the policy measures that will apply to G-SIIs (as released by the IAIS, referred to hereafter as the IAIS July 2013 Policy Measures) are consistent with the policy measures released by the FSB in November of 2011.

Description

FSB Designation of G-SIIs

The requirements that will apply to G-SIIs are yet to be fully developed. However, based on the IAIS July 2013 Policy Measures, they will address the following points.

Enhanced group-wide supervision

Enhanced group-wide supervision is likely to focus on risk governance, and in particular: the development by G-SIIs of strategic risk management plans (SRMP); liquidity measures; group supervision; the supervision of otherwise non-regulated financial entities; and policy guidelines for effective supervision. Key elements identified in the IAIS July 2013 Policy Measures state:

- The group-wide supervisor should have direct powers over holding companies to ensure application of a direct approach to consolidated and group-wide supervision.
- The group-wide supervisor should oversee the development and implementation of an SRMP in addition to a recovery and resolution plan (RRP). The SRMP should describe how the G-SII will manage, mitigate and possibly reduce its systemic risk, which could include measures such as the separation of non-traditional and non-insurance (NTNI) activities from traditional insurance business and/or restriction or prohibition of systemically important NTNI activities.
- Where separation of NTNI activities is contemplated, it is necessary to ensure self-sufficiency of the separate entities in terms of structure and financial condition (e.g., "no capital or funding subsidies, multiple-gearing, or double-leverage") or application of other "consequential measures" (such as restrictions of higher-loss absorbency requirements).
- Financial entities created in the process of separating NTNI activities should be under oversight of the direct supervisory authority and the group-wide supervisor.

Recovery and resolution planning

Under recovery planning, G-SIIs are likely to be required to develop their contingency planning for meeting severe stress scenarios, including a liquidity risk management plan and the identification of how resources could be made available through the sale of businesses. This could be covered within an SRMP that addresses the policy measures to be announced and the firm's own key risks, and may include the separation, restriction and/or prohibition of NTNI activities.

For resolution planning, the basis is provided by the FSB's "*Key Attributes for Effective Resolution Regimes.*" G-SIIs will therefore have to focus on critical economic functions and on whether legal operational structures represent a barrier to effective resolution. These attributes include: the establishment of a Crisis Management Group (CMG) for each G-SII; the "elaboration" of an RRP; resolvability assessments to be conducted through the CMG; and the adoption of institution-specific, cross-border cooperation agreements. For G-SIIs, effective resolution will also take account of the specific nature of insurance, including:

- Requirements to separate NTNI activities from traditional insurance activities;
- Possible use of portfolio transfers and run off arrangements as part of the resolution of entities conducting traditional insurance activities; and
- The existence of policyholder protection and guarantee schemes in many jurisdictions.

Loss Absorption

As a foundation for higher loss absorbency requirements, the IAIS will, as a first step, develop straightforward backstop capital requirements to apply to all group activities, including non-insurance subsidiaries. This is expected to be finalized ahead of the G20 Summit in November 2014. Higher-loss absorbency requirements are expected to be finalized by year-end 2015. Non-regulated entities will be required to have loss absorbency requirements that limit the scope for regulatory capital arbitrage, while there will be specific additional capital requirements for NTNI activities. Consideration will be given to any capital charges imposed by a national jurisdiction to mitigate systemic risk, and the calculation of the higher-loss absorbency requirement should consider whether the NTNI financial activities have been effectively separated from the traditional insurance business.

Separately, the FSB has also pressed the IAIS to introduce a global capital framework for insurers. This could have implications for the IAIS ComFrame project (which aims to establish a global framework for the supervision of internationally active insurance groups (IAIGs)), and also for the development of Solvency II.

Implementation Timetable

- Enhanced supervision, including group-wide supervision, will commence immediately for the initial set of G-SIIs. Work on SRMPs is also expected to begin immediately;
- CMGs should be established by July 2014 for the initially identified set of G-SIIs;
- RRPs, including liquidity risk management plans, should be developed and agreed by CMGs by the end of 2014;
- The IAIS will develop straightforward, backstop capital requirements for G-SIIs, to apply to all group activities including non-insurance subsidiaries, by the November 2014 G20 Summit; and
- Higher-loss absorbency requirements will be developed by year-end 2015 for implementation beginning January 2019 to the set of G-SIIs identified in November 2017.
- The IAIS is separately developing, and the FSB will review, a work plan to develop a comprehensive, group-wide supervisory and regulatory framework for IAIGs, including a quantitative capital standard. The timeline for the finalization of the framework will be agreed by the FSB by the end of 2013.

U.S. Financial Stability Oversight Council Designations

The Financial Stability Oversight Council (Council), created by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act), approved the designation of two nonbank financial firms, American International Group, Inc. (AIG) and General Electric Capital Corporation, Inc. (GE Capital), as systemically important financial institutions (SIFIs) in the United States on July 9, 2013. The designation marks the Council's first use of its authority under Title I of the Dodd-Frank Act and subjects the firms, or SIFIs, to supervision by the Federal Reserve Board and to enhanced prudential standards, including: risk-based capital and leverage; liquidity; single-counterparty credit limits; overall risk management; risk committees; and stress tests. A debt-to-equity limit has also been proposed for SIFIs. (Please refer to Regulatory Practice Letter 12-04 for more information.) Consistent with the statutory standard for designations by the Council, the Council determined that material financial distress at these firms – if it were to occur – could pose a threat to U.S.

financial stability. The Council states the designation does not constitute a determination that the company is currently experiencing material financial distress.

The Council had proposed to designate an additional nonbank financial firm, Prudential Financial, Inc., but the firm has challenged the designation and is awaiting opportunity to present its case to the Council. The Council must make a final determination within 60 days of the hearing. Press reports suggest that a fourth firm, MetLife, Inc., also an insurance company, is currently under consideration for designation as a SIFI in the United States and has reached "Stage Three" in the Council's designation process. In general, the Council makes a determination as follows:

- Stage One - initial selection of nonbank financial companies that, based on publicly available financial data, meet or exceed a $50 billion consolidated assets threshold and any one of the quantitative thresholds established by the Council for outstanding credit default swaps, derivatives liabilities, outstanding debt, leverage ratios and short-term debt ratios. Nonbank financial companies meeting or exceeding the criteria would move to the next evaluation stage;
- Stage Two - analysis of the risk profile and characteristics of each nonbank financial company using a six-category framework (size, interconnectedness, lack of substitutes, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) and "quantitative and qualitative industry- and company-specific factors"; and
- Stage Three – additional analyses performed in conjunction with the Office of Financial Research and with information provided directly by the nonbank financial company, including consideration of the resolvability of the nonbank financial company, the opacity of its operations, its complexity and the extent of any regulatory scrutiny. (Please refer to Regulatory Practice Letter 12-09 for more information on the Council's designation process.)

Notably, AIG, Prudential Financial, Inc., and MetLIfe, Inc. have been designated by the FSB as the three G-SIIs in the United States based on the IAIS assessment methodology.

Commentary

The insurance industry has long advocated the traditional insurance business model is not systemically risky and insurance activities were not a major influence on the global financial crisis in 2007 and 2008. The IAIS July 2013 Policy Measures support this position, stating, "G-SIIs are different from Global Systemically Important Banks (G-SIBs), in part because the traditional insurance business model is not inherently systemically important…. Insurers vary widely from banks in their structures and activities and consequently in the nature and degree of risks they pose to the global financial system. The activities that might make an insurer a G-SII can vary greatly from one insurer to another, but are generally related to their NTNI activities and any interconnectedness generated from those activities."

The application of the Policy Measures, and the need for additional capital, will likely rely to a large extent on a firm's ability to differentiate its traditional insurance and NTNI activities. Insurers with more significant NTNI activities could be subjected to higher requirements.

G-SIIs, and those that could potentially be designated, will want to consider and develop their capabilities in the following areas:

Enhanced supervision

- Meet the FSB's sound practice recommendations for risk governance.
- Ensure effective input to consolidated and coordinated group supervision.

Recovery planning

- Ensure adequate and robust risk management systems – including for liquidity – capable of measuring the impact of severe stresses on the business model.
- Determine trigger and stress scenarios.
- Examine the sufficiency of funding arrangements and ensure adequate access to contingency funding sources.
- Assess the ability to maintain and fund operations of critical functions and the resultant implications to conserve or restore the firm's own funds.
- Assess the opportunities to sell businesses, or otherwise reduce risk and leverage, in response to severe stress scenarios.

Resolution planning

- Identify relevant information on group structure, intra-group exposures and exposures to counterparties, other intra-group interdependencies and service level agreements.
- Develop a map of critical functions to legal entities to ascertain which business critical processes and operations are essential, and how they could be maintained by the authorities under a resolution.
- Explore whether there is a need to restructure legal and operational structures, liabilities, business lines and asset transformation activities to enhance resolvability.
- Consider how to maintain access and continued functioning of IT services and other firm infrastructure.

Loss absorbency

- Assess capital adequacy – and if necessary raise additional capital – against whatever loss absorbency requirements are developed.

Contact us:
This is a publication of KPMG's
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Contributing authors:
Hugh Kelly, Principal: hckelly@kpmg.com
Philip Aquilino, Managing Director: paquilino@kpmg.com
David Sherwood, Director: davidsherwood@kpmg.com

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