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FINANCIAL SERVICES

Evolving Insurance Regulation

The kaleidoscope of change
March 2014

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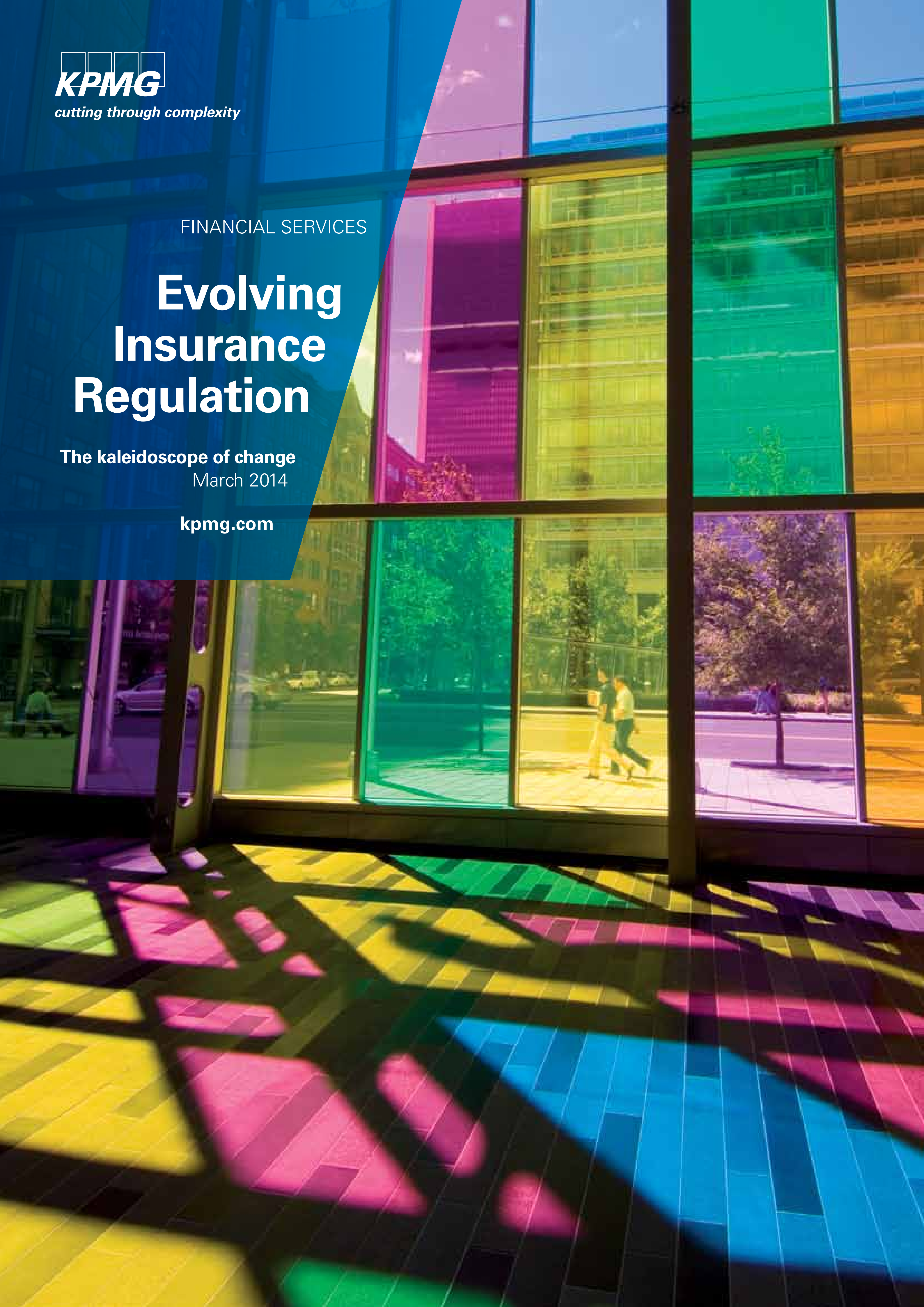

ABOUT THIS REPORT

This report is part of a regional series developed by KPMG's network of regulatory experts. The insights are based on discussion with our member firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies in each region.

For other regional reports, please contact fsregulation@kpmg.co.uk or see www.kpmg.com/regulatorychallenges

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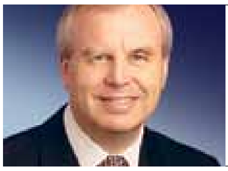
CONTENTS

Welcome to the fourth edition of Evolving Insurance Regulation. This year we have great pleasure in sharing with you the findings from KPMG's first global survey of Internationally Active Insurance Groups (IAIGs) regarding their concerns about new international regulatory requirements. We examine the significant developments occurring at the global level and the many changes now underway regionally that will have a substantial impact on the prudential and consumer protection requirements of insurers.

The kaleidoscope of change



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Almost six years since the financial crisis, the impact of the reforms put in place over the past few years to mitigate this recent crisis and to try to avoid another are now directly affecting insurers and their regulation and subjecting the sector to scrutiny by policymakers beyond traditional insurance supervisors.The International Association of Insurance Supervisors (IAIS) this year celebrates its 20th anniversary. Although the IAIS accomplishments over that time are significant, some would say that the future independence of the organization is now in question as the Financial Stability Board (FSB) exerts increasing authority over the IAIS's work plan.

In the past two years, this new influence can be evidenced in:

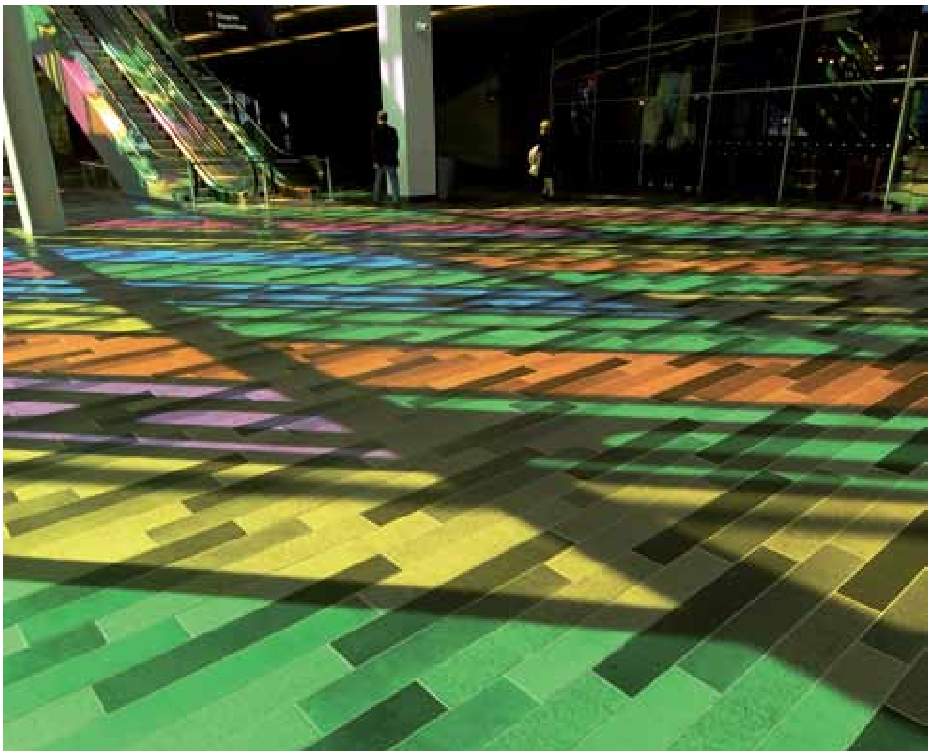
- the work on peer reviews (which the FSB insisted the IAIS undertake as soon as the insurance core principles were adopted);
- the identification of global systemically important insurers;
- the development of a global capital standard; and
- the recently announced reorganization of the IAIS reducing the transparency and access of meetings to observers.

The level of intervention by the FSB is certainly challenging the old regulatory structures, and insurance regulators are facing new challenges at the global, regional, and local level. The key challenge will be for insurance regulators to remain focused on the issues relevant to the insurance sector.

In the United States, the increasing central role of the Federal Reserve Bank as the consolidated regulator for a number of large insurance holding companies will give it authority for nearly a third of US insurance life premiums and a growing portion of non-life premiums. In addition, the Federal Insurance Office (FIO) alongside the US Department of Treasury has new momentum to set an agenda with the release of the Solvency Modernization report in December 2013, particularly in regard to group-wide supervision.

With the adoption of Solvency II growing nearer, European organizations are also poised to take on greater regulatory oversight of insurers. The European Insurance and Occupational Pensions Authority (EIOPA), created in 2010, already has authority to prepare technical standards, participate in supervisory colleges, and take action as a regulator if a Member State is not enforcing Solvency II. In 2013, EIOPA adopted a broad view of its powers to harmonize regulation by issuing Guidelines in four key areas – the Own Risk and Solvency Assessment (ORSA), governance, internal models, and reporting prior to the implementation of Solvency II. Member States were told to comply or explain why not.

With the decision to institute a single banking regulator in the Eurozone, i.e. the European Central Bank, EIOPA has also begun to raise the issue of its role as a direct supervisor. In his report to the European Parliament in 2013, EIOPA Chairman, Gabriel Bernadino, suggested that EIOPA



should have centralized oversight for approval of internal models and an enhanced supervisory role for the largest and most important cross-border insurance groups. KPMG supports such initiatives – and interestingly many in our survey had a similar view.

European level oversight is not limited to EIOPA. The European Systemic Risk Board (ESRB), charged with macro-prudential assessment of the financial system within the European Union, is now turning its attention to insurance. ESRB is establishing criteria for data collection from insurers to be incorporated in the work plan of EIOPA when that data call begins later this year.

KPMG's global survey provides key industry findings

To contribute to this debate, KPMG member firms have surveyed many of the leading global insurance groups regarding their views towards greater supervisory convergence and cooperation, focusing particularly on the IAIS ComFrame proposals. The results are detailed further on page 12.

Our survey revealed that many internationally active insurance groups (IAIGs) are very concerned that existing insurance regulators will be unable to agree new global standards due to their jurisidctional self-interests and related difficulties in aligning local and global objectives. A lack of political will to develop a global framework is viewed as a serious issue by those surveyed. Many respondents were worried that, notwithstanding good intentions, ComFrame could suffer from serious delays in the same way as Solvency II when policymakers were unable to reach agreement on fundamental requirements for several years.

Many IAIGs surveyed therefore remain uncertain as to the benefits that ComFrame will deliver and worry whether it will generate unintended consequences, creating an unlevel playing field, creating an environment for regulatory arbitrage and resulting in a system of regulation that is duplicative and burdensome. A large majority of IAIGs consulted believed ComFrame would result in additional costs related to systems changes and capital requirements. Such findings suggest that the IAIS has yet to make a compelling case of the benefits that ComFrame could provide.

Survey participants saw the need for greater clarity as to level of policyholder protection that ComFrame will deliver and how ComFrame will operate in practice – particularly whether it would replace existing supervisory regimes or would result in incremental changes. Many IAIGs were alarmed at the prospect of having multiple group supervisors, resulting in additional costs and confusion, and were supportive of having single group-wide supervisory structures in both Europe and the United States. Our results indicate that there is broad support for both EIOPA and the FIO to take on a larger role respectively in the supervision of IAIGs.

Our survey documented the on-going demand from IAIGs for more consistent international accounting and actuarial standards to address the valuation of assets and liabilities – standards for which KPMG member firms have long campaigned. There was also broad acknowledgement that greater consistency between the ORSA and regulatory disclosures and governance requirements would be beneficial. However, there was little support for international requirements relating to pricing or remuneration and even less enthusiasm for a harmonized global consumer protection framework.

What does this mean for insurance regulation and how will insurers be affected?

If ComFrame is to achieve international convergence and consistency in supervisory requirements, one of the most important issues to resolve will be that of establishing an appropriate level of policyholder protection – put another way, determining the risk appetite of supervisors with regard to the failure of an IAIG. An open and informed debate concerning minimum capital standards is needed. Such measures are necessary to achieve a harmonized approach and for ComFrame to deliver the promise efficiencies and cost-savings. Although these advantages are referenced in the debate, the IAIS is yet to undertake a formal cost/benefit analysis of ComFrame. Our view is that this should be given immediate priority.

Further, the IAIS needs to determine whether ComFrame will function like the Basel Accord for Banking (with the intention that individual countries will implement ComFrame into their local law and regulation replacing existing requirements) or whether a much looser regulatory arrangement is intended. This is a serious issue which requires open discussion to properly inform the structure and final requirements established for ComFrame.

IAIGs fear that ComFrame will lead to duplication of effort amongst supervisors and increased complexity, reporting and compliance costs and possibly capital requirements. While there remains a concern that ComFrame will become an additional set of regulatory requirements layered on existing national requirements, obtaining full industry support and engagement will remain difficult.

Next steps…

The next two years will be critical in the development of global insurance regulation, and the need for open, transparent and informed debate to achieve the most effective and efficient frameworks is paramount. Now is the time to challenge old paradigms and set out a new agenda as to how effective regulatory reform can be taken forward and who the best regulators for such a system will be – KPMG member firms look forward to continuing our active engagement in these endeavours.

Regulatory change is fundamentally re-shaping the insurance industry, creating strategic and operational challenges for insurers. This year's report examines how regulatory change at a global and regional level is altering the face of regulation and explores the implications insurers confront in responding to these developments. This publication focuses on the growing role of new policymakers in insurance regulation, the pressure to align insurance rules to the banking model, the growing programs to assess supervisory compliance, the growth of consumer protection laws and the latest insurance risk and International Financial Reporting Standards (IFRS) accounting changes.

Executive Summary

Regulatory change is fundamentally re-shaping the insurance industry, creating strategic and operational challenges for Insurers.

The international agenda for group supervision
In the changing face of insurance regulation we review how the International Association of Insurance Supervisors (IAIS) is coping with the increasing scrutiny from the Financial Stability Board (FSB) and the time pressure this generates. The IAIS is reorganizing its structure to complete its Common Framework (ComFrame) for the Assessment of Internationally Active Insurance Groups (IAIGs) and a global insurance capital standard. Both are to be effective by 2019. The IAIS will focus much of its energy for the next three years on its field-testing project to refine these proposals. The tests will involve both quantitative and qualitative work. Around 25 insurers and their supervisors have volunteered to work on the project. The results will have a significant impact on global regulation as various jurisdictions are expected to apply the resulting regulations to all insurance groups they supervise and not just those deemed globally active.

We highlighted in the foreword that KPMG member firms conducted a survey aimed at assessing the industry's readiness for ComFrame, examining the possible costs and potential benefits of a new global regulatory framework, in order to understand better how these changes might re-shape the market and assess the industry's readiness for change.

The systemic debate continues
In 2013, nine insurance groups were classified as global systemically important insurers (G-SIIs). The IAIS and the National Association of Insurance Commissioners (NAIC) have repeatedly said divestment of systemic risk (notably non-traditional, non-insurance (NTNI) activities is the goal of their financial stability policy. In our chapter on systemic risk, we look at the IAIS's policy measures for G-SIIs based on the general framework published by the FSB. These new measures include enhanced supervision, effective resolution and higher loss absorbency. The IAIS has committed to the FSB that it will develop a basic capital requirement (BCR) for G-SIIs by the end of 2014 and Higher Loss Absorption (HLA) standards by 2019. To that end it is conducting field-tests in late March on a factors based approach for the BCR.

The IAIS is also developing a process for macro-prudential surveillance to help supervisors assess and mitigate macro-financial vulnerabilities, including a toolkit and data template. The IAIS is assessing how it can work with other global bodies to improve global data collection in the insurance area.

Americas – the issue of extraterritoriality
Regulatory change, particularly the impact of Solvency II, is by no means limited to the IAIS. In our Americas perspective, we explore the changes made in response to European and global reforms.

Overall, significant reforms are taking place in the Americas in the area of solvency, accounting, corporate governance, and consumer protection – including countries under economic stress within Latin America.

The United States, now approaching its second IMF assessment, is exploring changes to its capital standards and group supervision options. New players such as the Federal Reserve Bank and Federal Insurance Office (FIO) are also assessing their role in the supervisory structure.

For many years, Solvency II has promoted the process of an equivalence assessment, with tangible benefits for companies from jurisdictions that are granted equivalence. A number of countries in the Americas region may be recognized with full or temporary equivalence for the revisions they are making to adopt a Solvency II-type regime.

Measurement of international standards
For many years, international standard setters have been writing new prudential requirements, but it is only now that a significant number of jurisdictions are actually implementing those reforms. At the request of the G20, several mechanisms have been put in place to assess the level of implementation and the effectiveness and clarity of international standards. The rise of international standard setters examines these oversight programs. We particularly explore the results of the ten IMF reviews of the new IAIS insurance core principles (ICPs) adopted in 2011 and provide an overview of the acceptance of the ICPs and difficulties in their implementation.

ASPAC raising standards
In previous reports we have described how the IAIS insurance core principles and new accounting standards are radically changing regulation in the ASPAC region. In our ASPAC perspective, we examine these changes, especially those related to increased governance requirements, market consistent valuation, improved ERM requirements, and higher solvency capital levels.

In particular, Asian regulators are concerned with the potential impact another crisis could have on local entity capital and liquidity management – and are also focused on reinsurance quality, in light of their exposure to natural catastrophe risk.

An increased focus on consumer protection
The focus on prudential standards initially pushed consumer protection issues at the IAIS to a back burner, but increasing attention has been focused on critical market place issues in the past year – both at the global standard setting level and in the jurisdictions. The IMF assessments now spend considerable time on the resourcing and supervision related to consumer protection, calling on regulators to take a more pro-active approach. Regulators' attention on product design and suitability is also growing, especially regarding investment products. We explore these issues in detail in the growth of consumer protection.

The EMA region – the emerging reform agenda
In our EMA perspective, we look at preparations in Europe to finally implement Solvency II and the impact the realization of this Directive is having on the insurance industry in the region. This work has begun already, starting with EIOPA's preparatory guidelines in the area of own risk and solvency assessment (ORSA), internal model approval, governance, and data reporting. During 2014, implementing measures and more detailed regulations will be released for consultation.

Regulatory change is also beginning to occur in the Middle East where changes are being made to align regulation with international practices. The focus of the region remains on local issues and Shari'a-compliant insurance products such as Takaful.

Africa has seen less change than elsewhere in the region, but South Africa continues to move forward with its Solvency Assessment and Management framework to become effective in January 2016.

Risk Management – within the context of profitability and sustainability
The global financial crisis highlighted the weaknesses of many insurers' risk governance and risk management frameworks. As many insurance supervisors merge with existing central bank functions, the approach to insurance regulation is likely to take on some bank centric methodology – many are understandably nervous about this. The positive side of this may be that banking regulators have begun to place more emphasis on understanding a bank's business model and capital needs. In the changing approach of insurance supervision, we explore how this increased focus on a bank's business model will force insurers to demonstrate the impact of business decisions on profitability and sustainability. The forward-looking ORSA will be central to that appraisal.

Regulators will be increasingly involved in monitoring the decisions of the Board of directors and how well these align with the risk appetite and risk culture of the company. Some companies may not be prepared for the intense scrutiny this will involve.

Accounting standards aligned with long-term business model
Finally, with the consultations complete on the IFRS insurance contracts exposure draft, the International Accounting Standards Board (IASB) has brought the publication of an IFRS closer to realization. In the Insurance accounting update chapter, we discuss how the new IASB proposals are more consistent with the insurers' long-term business model, but critical decisions remain to be addressed including volatility in profit or loss, the interaction between insurance contracts and financial instruments, presentation issues and the very high level of complexity in the standard overall.

Next steps…
There is little doubt that 2014 will continue with significant regulatory change, resulting in considerable strain on insurers. By being proactive and engaged in these fast-moving and important developments, insurers can nonetheless meet such challenges and stay ahead of the game. KPMG member firms help clients plan for forthcoming changes and realize their strategic objectives. Are you are adequately prepared for the kaleidoscope of change?

The changing face of regulation – the focus on group supervision

Significant regulatory change is occurring. The International Association of Insurance Supervisors (IAIS) this year celebrated its 20th anniversary, and while the IAIS accomplishments in that time are impressive, the future independence of the organization could now be in question as the Financial Stability Board (FSB) exerts increasing authority over the IAIS's agenda.

In the past two years, this new influence has been apparent in several IAIS developments including the development of a global capital standard; the identification and regulation of global systemically important insurers (G-SIIs); instituting peer reviews, which the FSB insisted the IAIS undertake as soon as the insurance core principles (ICPs) were adopted; and the reorganization of the IAIS which includes reducing the transparency of subcommittee meetings and limiting participation by observers. We will explore these issues throughout our report.

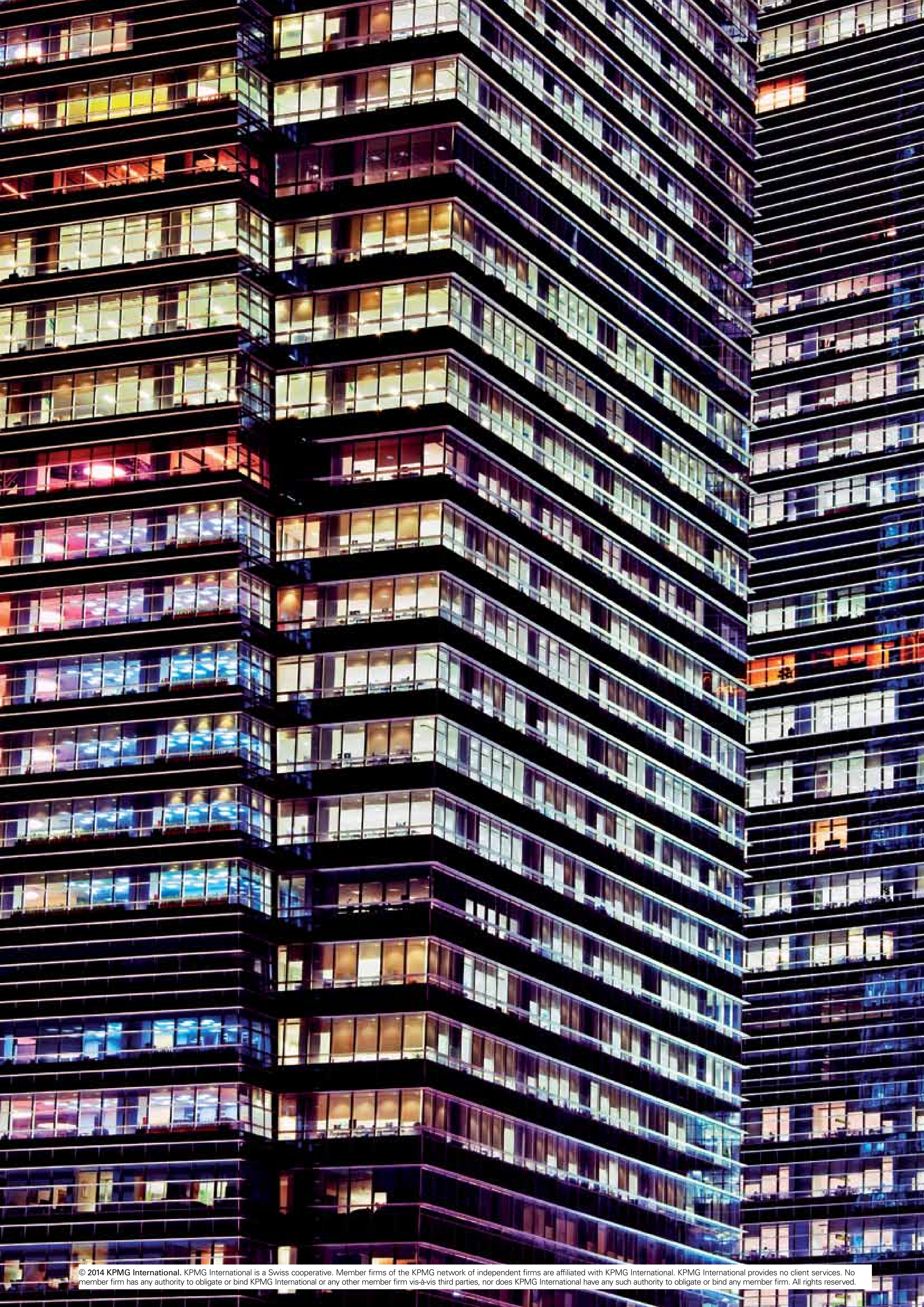
In this chapter we focus on capital and group supervision and the possible impact these changes will have on insurers as revealed in our survey of IAIGs.

Dawn of a new IAIS

In the past year under pressure from the FSB and G20, the IAIS made two critical decisions that will affect the direction of its overall policy and that of the largest insurers. The IAIS has decided that insurance supervisors should exercise comprehensive supervision over the head of the insurance group and that, as part of that supervision, there should be a global risk-based insurance capital standard (ICS).

Yoshi Kawai, Secretary General of the IAIS, in his 2013 annual report to the membership, described the decision to develop a global insurance capital standard as the 'dawn of a new IAIS'. Kawai said that the ICS would provide the common language that supervisors need to communicate with each other and the tools to address financial stability issues.

The decisions regarding these developments will impact the insurance core principles, the ComFrame, and systemic risk. The IAIS now envisions a complex set



ARCHITECTURE OF IAIS INTERNATIONAL SUPERVISORY REQUIREMENTS

Type of entity	Legal Entity	Group	Internationally Active Insurance Group (IAIG)	Global Systemically Important Insurer (G-SII)
Supervisory requirements and actions				
First tier **ICPs**	ICPs that apply only to legal entities	ICPs that apply to legal entities and groups		
Second tier **ComFrame**			ComFrame	
Third tier **G-SII package**				G-SII package

Source: IAIS newsletter, Issue 15, April 2013

of regulatory standards, which will apply at either the legal entity level, the group level, or to IAIGs and G-SIIs. The insurance core principles (ICPs) provide the base line for all the other standards. Rules for IAIGs and G-SIIs may go beyond the ICPs, but should not conflict with them. The architecture envisioned by the IAIS is illustrated in the diagram on this page, although final decisions as to where certain specific requirements such as the ICS apply are yet to be decided.

Group-wide supervision

At the time of adoption of the ICPs, the IAIS allowed for either direct or indirect supervision of insurance groups. As acceptance of group supervision has increased in the past few years and because many found the references to group-wide supervision in the ICPs 'incomplete, confusing, and subject to varying interpretations[1]' the IAIS has undertaken a revision of the references to group-wide supervision throughout the core principles, although the focus of group supervision requirements will remain in ICP 23.

The IAIS has appointed a working group to address the issues. As part of their work, the working group has suggested clarifying the definition of an insurance group and confirming that the scope of the ICPs is directly applicable to the insurance holding company (the point at which all the insurance entities come together), not the financial conglomerate or the wider group. The IAIS will thus be in line with the Joint Forum definition that the head of the insurance group is the lowest entity at which exerts control over all insurance operations. This may be a financial conglomerate, but is more likely to be a separate holding company. Any other financial institution or non-regulated entity which fall under that insurance holding company is to be considered in the supervision of the insurance group, but any entity above the holding company should be considered only as it poses a risk to the insurance group. This clarification, once approved by the Technical Committee, will also clarify the scope of ComFrame.

The working group is rewriting ICP 23 and discussing a series of clarifying changes to a number of other ICPs to ensure that they include provisions for supervision of insurance groups, including the head of group. The main thrust of the changes is to ensure that supervisors have authority for group-wide supervision of insurance

The insurance core principles provide the base line for all the other standards. Rules for IAIGs and G-SIIs may go beyond the ICPs, but should not conflict with them.

1. Presentation to IAIS Insurance Groups and Cross Sectoral Issues Subcommittee, Cracow, Poland September 2013 by the Joint ICP 23/Fin Con WG, page 4, based on the IAIS's Report from the Review Teams Conducting the Self-Assessment and Peer Review of ICPs 1,2, and 23. http://www.iaisweb.org/Supervisory-Material/Other-supervisory-papers-and-reports-764

holding companies. The test for these powers is to be outcomes-based, as defined in the Joint Forum Principles on Financial Conglomerates. The use of the terms direct and indirect supervision will be dropped. The IAIS will also be working with the IMF to develop guidance for the assessment of group-wide supervision in the FSAPs to avoid the problems encountered with ICP 23.

Insurance capital standard

The details of the IAIS insurance capital standard and the scope of its application are still under debate, but it is clear that it will at a minimum apply to IAIGs and will replace the current capital requirement in ComFrame. The ICS will be developed by 2016 and be operational by 2019. The IAIS is working on the assumption that the ICS will be developed as a model group-wide prescribed capital requirement (PCR) as defined in ICP 17.[2]

The ICS will be fleshed out through field testing in 2014 and 2015. In the 2014 quantitative field test, the IAIS is requiring volunteers to provide information on four balance sheets, for comparative purposes.

1) The group's existing economic capital models on a consolidated group-wide basis without modification. The IAIS will determine a set of principles that it will create which will be required for comparability purposes while maintaining appropriate risk sensitivity.
2) The group's consolidated statutory balance sheet in its home jurisdiction (baseline data only).
3) The group's consolidated balance sheet based on generally accepted accounting principles in the home jurisdiction.
4) A Market Adjusted Valuation using public financial reporting information adjusted based on criteria set by the IAIS to increase comparability. Although the IAIS is not proposing a fully market-based valuation balance sheet, it is asking for market-based valuations using specifications provided by the IAIS for material assets and liabilities. Capital resources will be adjusted based on the ComFrame draft which exclude goodwill, deferred tax assets, certain reinsurance recoverable and subordinated debt. Liabilities will be based on a current estimate, excluding any prudential margins, although simplified approximation will be allowed. The IAIS will prescribe an adjusted risk free rate curve to be used in the calculation of liabilities.

Stress tests will be used to assess the responsiveness of the balances sheets. These will include an interest rate stress, an equity stress, a mortality stress (for life) and an increased claims stress (for non-life).

The IAIS will then issue a consultation draft on ICS in December 2014. The IAIS has been exploring the possibility of testing two different target criteria for the ICS, preliminarily described as 99.5 percent VaR and 90 percent CTE over one year.[3]

ComFrame

In 2009, in the wake of the global financial crisis, the IAIS expanded its core principles to 26 and began the development of a Common Framework for the Supervision of Insurance Groups (commonly referred to as ComFrame). The ComFrame project included three formal consultation periods to outline the framework and initial requirements, one each in the summers of 2011 and 2012 and the third consultation was completed in December 2013. The IAIS is currently evaluating the final comments.

In the course of the development phase, the ComFrame proposal has undergone considerable revisions in its wording, but the scope of the project has changed little. The 2013 consultation draft was been reduced to three modules. It also added certain preconditions assumed to be in place related to legal authority of the supervisor, sufficient regulatory resources and confidentiality.

Module one focuses on the definition of an IAIG that will be subject to ComFrame. Although there is some supervisory discretion, the criteria have changed little in three years:

- A group must write business in three or more jurisdictions, including branch activity.
- The percentage of gross premiums written outside the home jurisdiction is at least 10 percent of the group's total gross written premium.
- The group must have total assets related to the insurance business of at least US$ 50 billion or gross written premiums of at least US$ 10 billion.

Module one also sets criteria for the selection of the group-wide supervisor if there is a disagreement in the college, based on location of the head of the IAIG, where insurance business activities are controlled, where the largest proportion of balance sheet is located, or where the main business activities are undertaken. The IAIS is currently field testing the criteria and the level of discretion needed for deciding if a group should be classified as an IAIG.

Module two focuses on the action that must be taken by the IAIG. These requirements related to management structure, governance, enterprise risk management, and capital adequacy. The biggest issue for this module concerns capital resources and requirements.

COMFRAME SUMMARY

→ Module one:
The scope of ComFrame
- definition of an IAIG and processes for identifying IAIGs.
- scope of ComFrame supervision and how supervisors should determine which entities should be within the perimeter of supervision.
- identification of the group-wide supervisor.

→ Module two:
The IAIG (the standards with which the supervisor will require an IAIG to comply)
- the IAIG's legal and management structures.
- the group governance framework and expected roles of the Governing Body and Senior Management of the Head of the IAIG.
- requirements for Enterprise Risk Management (ERM).
- group-wide ERM policies that an IAIG should develop and implement.
- the process the IAIG follows to assess its capital adequacy.
- reporting and disclosure requirements for IAIGs.

→ Module three:
The supervisor (the processes whereby supervisors assess whether IAIGs meet the requirements in module 2)
- the group-wide supervisory process.
- cooperation and interaction between involved supervisors and the requirement for supervisory colleges.
- measures for addressing crisis management and resolution.

Source: IAIS 2013 Draft ComFrame. http://www.iaisweb.org/Common-Framework–765

2. Draft Summary Record, IAIS Joint Financial Stability and Technical Committee Meeting, January 27–28, 2014
3. Summary of January 27-28, 2014, IAIS Joint Financial Stability and Technical Committee Meeting.

It is not clear how the proposed BCR and ICS will operate in practice with the current capital requirements... How these various capital measures will be aligned requires further articulation from the IAIS.

A decision on these issues has been deferred to field-testing, as described below.

Module three details the role of the group-wide supervisor and the coordination process in the colleges. Only two sections of this module (the group-wide supervisory process and supervisory colleges and cooperation) were released in the consultation. The third area, crisis management and resolution, is still being drafted pending additional work by the Financial Stability Board (FSB) on the Key Attributes of Effective Resolution and Recovery Plans, but will include requirements for cooperative agreements, recovery and resolution plans, and crisis management groups. The IAIS continues to debate which of these aspects will apply to IAIGs and which will only apply to global systemically important insurers (G-SIIs). This section will be released for consultation in mid-2014. It is also possible that the IAIS or a newly formed FSB working group on crisis management for insurers might develop a binding agreement regarding distribution of funds in a crisis to avoid the ring-fencing of available funds by local supervisors. However, such a proposal would likely face opposition from certain regulators.

Industry comments throughout the drafting have focused on the overly prescriptive nature of some of the requirements, such as the need for a group actuarial audit and group-wide underwriting and claims policies. Another area of more recent concern is the definitions of capital resources, especially the establishment of two tiers of capital and the exclusion of certain items such as intangibles, subordinated debt, and deferred tax assets from tier-one capital. Observers have also encouraged the IAIS to expand upon the role of supervisory colleges in ComFrame, pointing out that there are unanswered issues as to how to resolve conflicts among supervisors.

Although the IAIS will be assessing the comments made during the ComFrame consultation period and considering amendments in June 2014, substantial changes are not expected. Another consultation will take place in 2015 after the ICS proposal has been completed.

Field-testing

The IAIS will be field-testing all three ComFrame modules, in addition to the ICS. Some of these tests are quantitative and some are qualitative. Over 25 insurance groups and their group-wide supervisors have expressed an interest in participating in the tests, including the nine designated G-SIIs. The field test will run until the end of 2018, at which time the complete ComFrame package is to be adopted. Because the IAIS is also working on capital requirements for G-SIIs and IAIGs, work on these areas has been combined with the ComFrame field testing.

Other activity impacting ComFrame

In 2013, the IAIS approved an issues paper on Supervision of Branches which was based on a survey of IAIS members as to how branches were regulated in each jurisdiction[4]. The report was prompted because of concerns in some jurisdictions that branches were not as secure as subsidiaries, although in the end the report presented a more balanced view.

The IAIS is also expected to release an issues paper on Approaches to Governance in 2014. The paper arose due to the growing awareness of the divergent approaches to group governance adopted within groups, and the different impact and demands those approaches can have on control functions which form a key element of the corporate governance framework of a group.

KPMG PERSPECTIVE

The issue of a branch versus subsidiary structure has taken on more importance given the decisions that would need to be taken in a resolution scenario. In particular, where there are no local asset requirements and/or prior permission requirements regarding access to assets by the group parent.

We would expect that under this environment, jurisdictions may want to revisit branch requirements to ensure they have greater control over the solvency of the local branch operations to protect local policyholders.

IAIS reorganization

The IAIS announced last year that it would be streamlining its structure to improve its efficiency and target its resources on the major tasks related to capital, groups, and G-SIIs. Part of the expressed objectives of the reorganization was to enable the IAIS to adapt to 'evolving external expectations'.[4]

Details of the plan are being finalized, but in generally IAIS subcommittees will be disbanded in favor of smaller, task oriented working groups. These working groups will be encouraged to engage more by conference calls and will be closed to observers. Participation by observers in the IAIS policy process will instead be limited to special hearings at the Technical and Executive Committee meetings and formal consultations. Observers would be excluded from all other meetings unless invited as experts.

4. IAIS Issues Paper on Supervision of Cross-Border Operations Through Branches, October 2013

For more information on regulatory reform

Evolving Insurance Regulation 2013
http://www.kpmg.com/global/en/issuesandinsights/articlespublications/evolving-insurance-regulation/pages/evolving-insurance-regulation-2013.aspx

TIMELINE

2013 – 2019

Oct 2013–Mar 2014
A survey was sent by the IAIS to supervisors asking them to test the criteria for identification of IAIGs. On the request of the Financial Stability Board, it also asked supervisors to describe the level of authority within their jurisdiction over insurance holding companies.

December 2013–February 2014
Consultation on the basic capital requirement (BCR) for G-SIIs and possibly for IAIGs.

March–August 2014
A quantitative test of both the basic capital requirements and the first phase of testing for the Insurance Capital Standard (ICS) focusing on the balance sheet. The IAIS at this point plans to test at least two valuation approaches: the individual group economic capital model and an adjusted balance sheet (generally market-based) looking at the responsiveness (risk sensitivity) of the balance sheet to stress tests and comparability. Stress testing will run from June to August.

July 2014
A second consultation on the BCR focusing on calibration and application.

July–September 2014
A qualitative test of the Module Two requirements, specifically data reporting. Some questions will be directed to supervisors and others to the volunteers. Volunteers will be asked to identify gaps between ComFrame proposals and current practices. This phase also may include questions related to available capital resources.

September 2014
BCR presented to FSB and implemented by G-SIIs in early 2015.

Mid to late 2014
Consultation on crisis management and resolution text for ComFrame.

October 2014 – March 2015
Qualitative field test on Module 3 regarding the role of the supervisor.

December 2014
Consultation on insurance capital standard (ICS) and HLA.

March – May 2015
Qualitative field-test on resolution and recovery.

March–May 2015
Second quantitative test of the capital requirement and the HLA requirement (for G-SIIs only).

November 2015
Completion of HLA requirements for G-SIIs focused on systemic risks, not insurance risks.

December 2015
Consultation on comprehensive draft of ComFrame reflecting field-testing results.

March–May 2016
Possible final quantitative test.

March–May 2016
Qualitative field-test including supervisory powers and resolution.

March–May 2017
Second qualitative field-test on resolution and crisis management.

April 2017
Volunteers begin reporting using the ICS.

December 2017
Final consultation on comprehensive draft of ComFrame.

2018
All IAIGs begin reporting ICS to supervisors.

October 2018
ComFrame adopted.

2019
Full implementation of ComFrame.

Source: KPMG International, March 2014

/ KPMG PERSPECTIVE

We very much support IAIS efforts to achieve a more coherent and consistent set of international requirements for the supervision of IAIGs.

However, an open and transparent debate is required to engage all stakeholders on such an important initiative. The IAIS must be clear about the level of policyholder protection (confidence level) it is seeking as part of these reforms. Attempting to construct a new framework in the absence of an agreed target capital level for regulatory purposes will make the task of obtaining agreement amongst all stakeholders, particularly insurance supervisors themselves, much more difficult.

It is also not clear how the proposed BCR and ICS will operate in practice with the current capital requirements of regulators once completed. How these various capital measures will be aligned requires further articulation from the IAIS.

A fully informed debate concerning the appropriate level of capital for IAIGs to hold for economic and regulatory purposes should be held and the results of those outcomes should then inform the construction of any RBC framework and subsequent requirements, especially with regards to calibration, stress tests and other risk management and governance requirements.

Industry's readiness for ComFrame

In December 2013, KPMG member firms conducted an online survey on the possible costs and potential benefits of global regulatory change, in particular the development by the IAIS of their ComFrame proposals. ComFrame is designed to develop a common framework for the supervision of Internationally Active Insurance Groups (IAIGs).

Our survey was aimed at understanding how these changes might re-shape the market and assess the industry's readiness for change.

30 IAIGs were invited to participate in the survey, with nearly two thirds providing valuable insights which are summarized below.

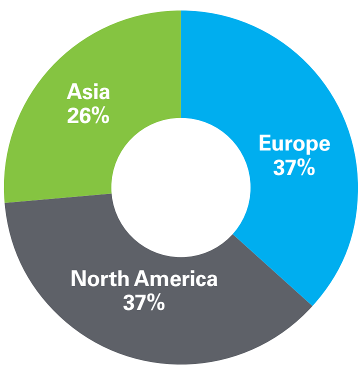
Main findings:

- High-level awareness amongst IAIGs surveyed of the IAIS ComFrame developments, with 89 percent awareness but only 50 percent currently preparing.
- Good support for the development of a global prudential framework and little support for a harmonized set of consumer protection requirements. However, a number of IAIGs remain uncertain of the merits of developing common standards;
- Concerns regarding unintended negative consequences, such as an unlevel playing field and regulatory arbitrage to ComFrame being duplicative and burdensome for firms.
- Clear demand from IAIGs for consistent international accounting standards and better harmonization of legal frameworks to enable ComFrame to become effective across multiple jurisdictions.
- Strong support for ComFrame to be risk-based and address valuation standards – both at an accounting and actuarial level – and for consistent requirements relating to the ORSA, regulatory disclosure and governance requirements.
- No support for consistent pricing or for global remuneration requirements.
- Challenges in implementing a global framework, centered on a lack of standard accounting practices for the valuation of assets and liabilities. Concerns were also raised from IAIGs that insurance supervisors themselves may be unable to agree upon new global standards due to their own self-interests and difficulty in aligning local and global objectives.
- Concern that a lack of political leadership to develop a global framework could seriously hamper international efforts. Respondents were concerned that ComFrame could follow a similar path as Solvency II in terms of the difficulty in reaching agreement.
- Fear that ComFrame would result in additional costs, particularly concerning systems changes and capital and unlikely to result in any expense reductions.
- Most IAIGs surveyed were unable to estimate their current regulatory resourcing costs.
- Support for a single group-wide supervisor in both Europe and the US markets, with concerns raised over having multiple group-supervisors for an IAIG creating unnecessary costs and confusion.

Global participation

The survey received responses from 19 of the world's leading insurance groups, with a good geographical spread.

In which region is your organization's headquarters?



Source: KPMG International, March 2014

Strong awareness of the IAIS ComFrame requirements amongst IAIGs

It was encouraging to see that 74 percent of respondents were fully aware of the IAIS ComFrame developments, with only 26 percent of respondents having a moderate to low level awareness of ComFrame. This is a positive sign for the IAIS, and demonstrates that IAIGs are actively wanting to be engaged and are committing resources to assist global regulators to shape the new international insurance framework.

Support for a global framework to harmonize prudential regulatory requirements

There was strong support for the development of a global framework to harmonize insurance prudential regulatory requirements with two thirds of the IAIGs surveyed in favour. In contrast, only 35 percent of survey participants said they would support the harmonization of conduct requirements globally.

There was broad acknowledgement that harmonized requirements should lead to group supervision being more effective, efficient and consistent across jurisdictions, particularly for the operations of global insurance players and allowing regulators and analysts to better understand the financial adequacy of insurance firms globally, however, there were a number of significant caveats, predominantly:

- The differences in the way insurance business is conducted among different jurisdictions. There was a strong view that without taking account of such differences, global standards may produce unintended negative consequences both for financial stability and for consumer protection;
- Risks creating an unlevel playing field with duplicative and burdensome requirements, and at worst, usurping the sovereignty of jurisdictions. Enhancements to solo supervision was considered important in this regard;
- New and completely different and conflicting standards relative to other supervisory regimes that also apply to insurance groups; and

• ComFrame's too rapid introduction and poor planning, which could at worst destroy the availability of insurance protection products for consumers and the financing market for long-term investments.

Respondents said that until there is consistency of international accounting standards and legal frameworks, ensuring cross-border consistency, regulatory arbitrage would result. Further, there were concerns that these reforms could have a particular EU bias and result in the European Union continuing to have excessive influence.

In regards to conduct regulations, there was considerable doubt as to whether international harmonized requirements were necessary. This was mainly due to the need for regulations to be appropriate to the local market, economy and business environment. For consumers, comparability among insurers in a jurisdiction is more relevant than international comparability.

→ Core components of a global framework

Survey participants were asked if a global framework could be developed, what they would specifically like to see as core components of a new regulatory framework.

The results showed a strong desire amongst the IAIGs for consistent global requirements relating to a risk-based capital framework and valuation standards – both accounting and actuarial, with other strong support for broader risk management requirements, including the ORSA, regulatory disclosure, governance requirements and consistency regarding the approach taken to investments/assets.

In contrast, there was no real support for consistent requirements relating to either pricing or remuneration, and a mixed response to whether conduct requirements should be harmonized at a global level.

89%

89 percent awareness of ComFrame but only 50 percent of IAIGs surveyed are currently preparing.

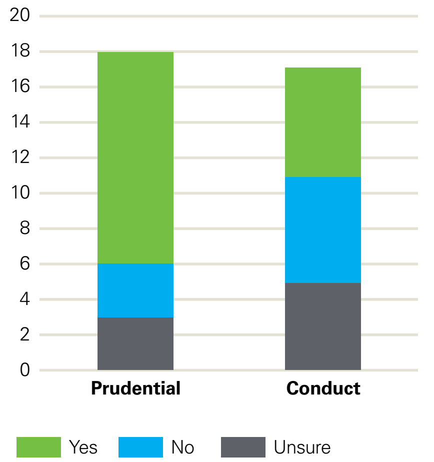
2/3

Two thirds of IAIGs surveyed support a global framework to harmonize insurance prudential regulatory requirements.

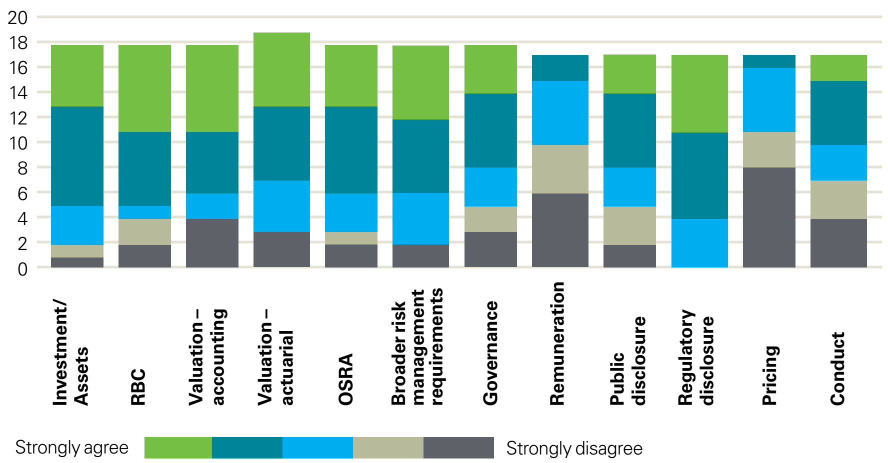
35%

Only 35 percent of survey participants support the harmonization of conduct requirements globally.

Would you support the development of a global framework to harmonize insurance regulatory requirements?



If we assume a global framework could be developed, what would you like to see as core components of a new global regulatory framework? Consistent requirements relating to:



Industry's readiness for ComFrame continued

Challenges in implementing a global framework

When asked what IAIGs believed were the main challenges in implementing a global framework, the responses mainly centered on:

- A lack of understanding among supervisors on the nature of insurance business (cited as being too bank centric);
- The lack of standard accounting practices – especially the valuation of insurance liabilities, but also in regard to the valuation of assets;
- Different/inconsistent interpretations and applications by various stakeholders around the world and in reaching agreement;
- The difficulty and challenge of getting various regulators to align with one view, especially the US regulators and potential confusion concerning the FSB's role. The lack of supervisory cooperation and coordination was commonly referred. It was also considered that IAIGs may fear losing their role with a local regulator;
- Legal challenges with regard to effective group-wide resolution;
- The degree and complexity on reaching agreement on risk and capital calibration requirements, particularly considering the degree of different existing frameworks/ starting points;
- Differences in product nature – even that the name of some products look the same;
- Conflict of interest of supervisors who are tasked with creating a supervisory framework that undermines their local authority; and
- Divergent legal authorities reflecting a current lack of political leadership or will by policymakers to reach consensus with the current EU/US differences cited as an example.

Some views were expressed comparing the work undertaken in the banking sector and other cross-border trade agreements to reach harmonized requirements to that of insurance and how some of these developments have taken decades to reach yet insurance supervisors are looking at a much quicker timetable of reform.

Costs

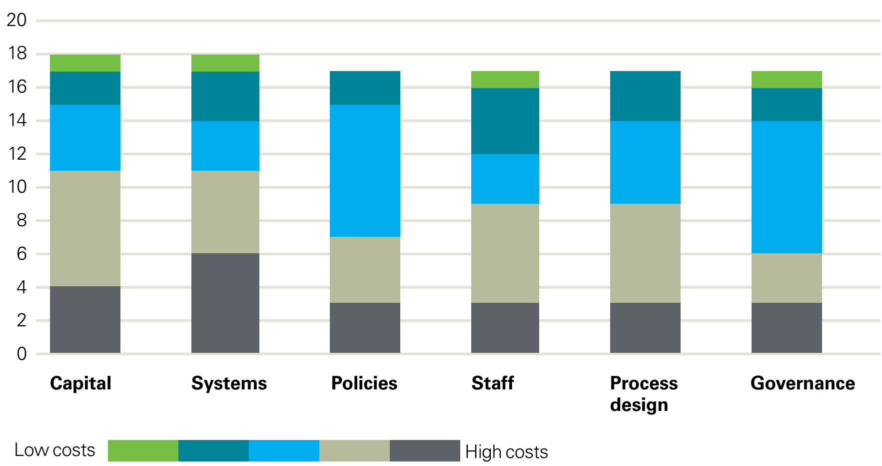
In regards to what IAIGs considered were the main costs associated with the ComFrame implementation, the two main significant items related to systems changes and capital, with 61 percent of IAIGs expecting high costs respectively.

There was also a view that costs were likely to be medium to high around governance, policies and process design implementation. Staffing costs were considered to be moderate.

61%

61 percent of IAIGs surveyed expect higher costs resulting from ComFrame.

What do you see will be the main costs associated with ComFrame implementation?



→ Likelihood of any expense/ cost reductions

There was a strong response from 72 percent of IAIGs who believe it is unlikely that ComFrame will result in any expense/ cost reductions for their organization – from either a prudential or conduct framework. When asked why they considered either costs or expenses would increase or decrease, participants were not hopeful that ComFrame would result in less duplication of effort across the group, although there was some expectation that ERM frameworks could be streamlined. Instead, the majority of responses were critical, due to:

- increased likelihood of additional costs if groups are required to prepare group balance sheets and capital requirements that are different to the existing regime and internal models where in use;
- increased governance and reporting costs; and
- generally held views that currently all proposals are add-ons, redundant and not being properly coordinated.

→ Support for a single group-wide supervisor in the US and Europe

55 percent of IAIGs supported the view that there should be a single group-wide supervisor in the US and half of respondents supported a single supervisor for European markets.

When asked why they answered either in favour or against a single group-wide supervisor, the responses from the IAIGs were again mixed. Respondents commented that:

- US group supervision is likely to be more effective at a federal level rather than current State approach;
- A single group-wide supervisor can look into the overall health of the organization and would not necessarily prohibit a local supervisor having influence over a local entity;
- The ideal communication route between an IAIG and supervisors (or a supervisory college) should be "holding company or headquarter of the IAIG" and "group-wide supervisor" under the ComFrame. Multiple group-supervisors for one IAIG could create unnecessary burdens or confusion; and
- That there should be a single group-wide supervisor for the whole group across all jurisdictions (irrespective of US or Europe).

→ Capital requirements

In contrast, other responses highlighted that there should be general agreement regarding capital frameworks to provide adequate consumer protection, while many other respondents questioned the ability of different regulators to come to agreement on a framework such as ComFrame and that ultimately there could be a lack of progress given negotiations will struggle to reach agreement, similar to developments in Solvency II. There were also other views expressed that US-specific asymmetries would prevail while ComFrame was not practical in times of crisis.

→ GWP spend on regulation

A number of respondents were unable to provide an estimate regarding the current resourcing costs specifically devoted to regulation, as a percentage of gross written premiums that was currently being provided. This was particularly evident in relation to consumer protection matters. This uncertainty also extended across to prudential issues, with most estimates ranging between 1–2 percent of GWP, with one respondent citing 5–10 percent while another estimated at 40 percent.

→ Preparations for ComFrame

IAIGs were evenly split between those insurance firms which had started to engage in the ComFrame developments and those that had not.

The increasing pressure on global systemically important insurers – G-SIIs

At the request of the G20 and the Financial Stability Board (FSB), the IAIS developed an assessment methodology to identify any insurers whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity. Any such insurers would be regarded as systemically important on a global basis.

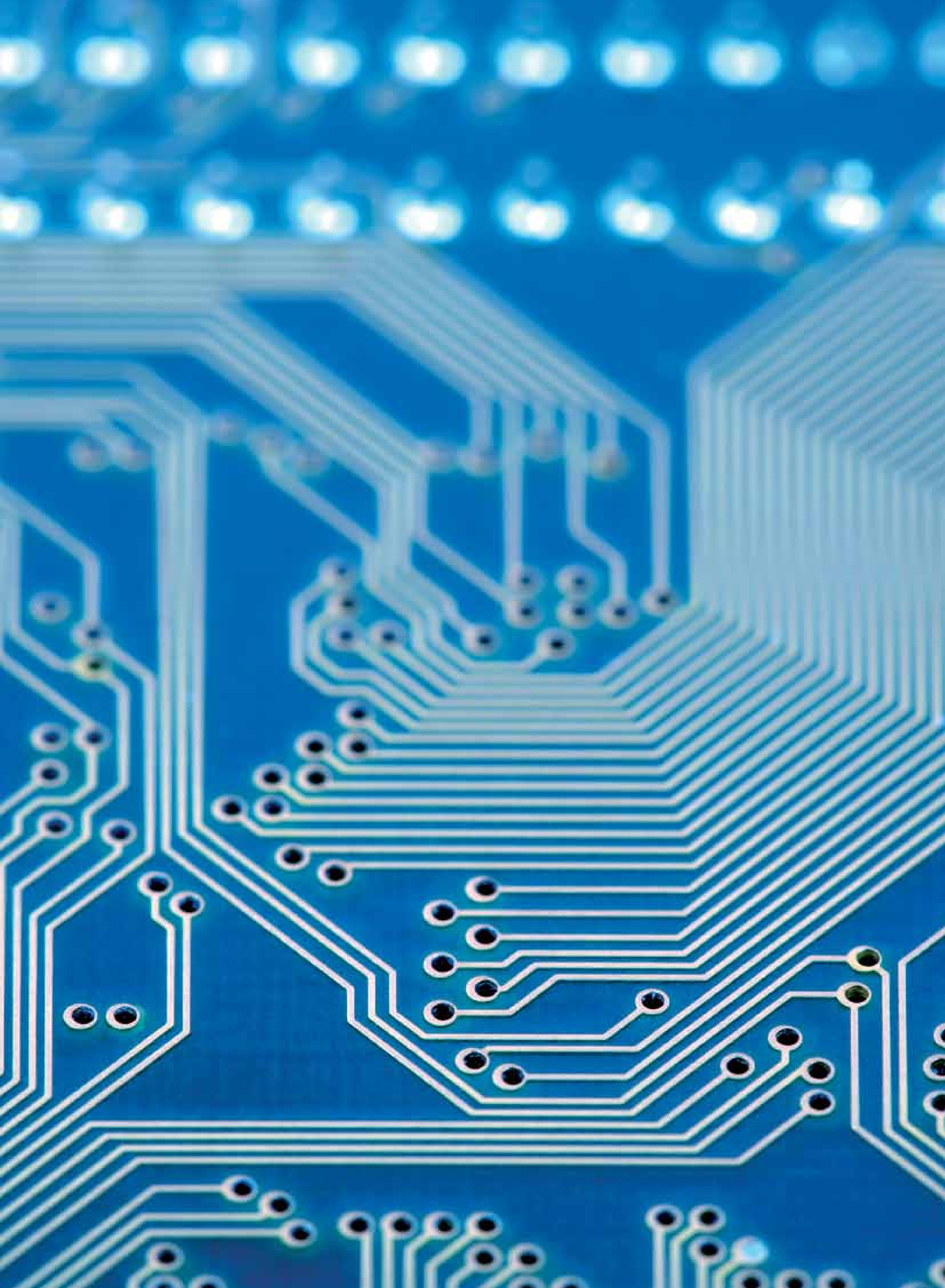
The FSB has identified nine groups as global systemically important insurers (G-SIIs) based on the International Association of Insurance Supervisors (IAIS) methodology. The groups are: AIG, Allianz, Aviva, AXA, Generali, MetLife, Ping An Insurance, Prudential Financial, and Prudential plc.

The decision on possible G-SII designation of major reinsurers has been deferred until July 2014 to provide more time to evaluate the circumstances of the individual reinsurance companies in question. The IAIS has said that whereas, the G-SII methodology focuses on non-traditional or non-insurance (NTNI) activities, for reinsurers the issues relating to substitutability and interconnectedness are more complex than for insurers and require further study and analysis.

Assessment methodology

Last year we outlined how the IAIS developed its methodology to assess the systemic importance of insurers and the industry continues to raise concerns that the definition of non-traditional insurance business remains unclear, saying that what is traditional in one jurisdiction may be untraditional in another, especially regarding selection of products such as variable annuities. Understanding what is meant by the terms becomes critically important since the IAIS has said that its main goal is for G-SIIs to de-risk from NTNI activities. Companies are saying that it is impossible to meet this goal without a full understanding of the calculations and definitions.

This issue further becomes important to resolve given many jurisdictions are now contemplating extending such requirements to local domestic systemically important insurers (D-SIIs). For example, the Prudential Regulation Authority (PRA) in the UK has recently announced a review of its principles for business, and adopted some new fundamental requirements that will guide the PRA in its supervision of firms. One of the new fundamental requirements for insurers is that they will need to prepare for resolution, so that if required, the insurer can be resolved in an orderly manner with a minimum disruption of critical services. Such a move is a significant development which is likely to be followed similarly by many other supervisors.



G-SII policy measures

The IAIS has also developed a framework of policy measures for G-SIIs. The framework is based upon the general framework published by the FSB with adjustments to reflect the distinct features of the insurance sector. As with the assessment methodology, the policy measures framework reflects the factors that make insurers, and the reasons why they might be systemic, different from other financial institutions.

Additional measures G-SIIs must undertake include:

Enhanced Supervision: The first measures to be applied to G-SIIs relate to enhanced supervision, built on the IAIS's Core Principles and the FSB's paper on Supervisory Intensity and Effectiveness. These include the development of a systemic risk management plan and an enhanced liquidity plan. The purpose of the systemic risk management plan is to demonstrate how the group will manage, mitigate, and possibly reduce its systemic risk. The group-wide supervisor is required to have direct powers over holding companies to ensure that a direct approach to consolidated and group-wide supervision can be applied. It is expected that ComFrame measures, when completed, will also apply to G-SIIs.

Effective Resolution: The second of the reforms to be outlined this year require the development of crisis management groups, the elaboration of resolution and recovery plans, the conduct of resolvability assessments, and the adoption of institution-specific cross-border cooperation agreements. The IAIS proposals take account of the specifics of insurance through the inclusion of plans for separating NTNI activities from traditional insurance activities, the potential use of portfolio transfers and run-off arrangements, and the recognition of existing policyholder protection and guaranty schemes. The FSB is expected to release more specific guidance on resolution plans for insurers in the near future and is expected to release an insurance specific annex to its paper on Key Attributes.

Higher Loss Absorption (HLA) Capacity: As outlined by the IAIS, in 2015 G-SIIs will be subject to basic capital requirements (BCRs). The BCRs will serve as the foundation for HLA requirements for G-SIIs, which will apply in 2019. Both the BCRs and HLA requirements are part of the IAIS ComFrame field-testing for 2014 and 2015. The IAIS has said that in applying the HLA capacity, consideration should be given to whether a firm's non-traditional insurance and non-insurance financial activities have been effectively separated from the traditional insurance business. Where possible, the HLA may be targeted at the entities where the systemically important activities are located.

Basic capital requirements

The FSB has requested that the IAIS develop Backstop[5] Capital Requirements (BCR) as part of the Global Systemically Important Insurers (G-SIIs) framework by the end of 2014. There is considerable debate as to how to approach the BCRs. Currently, the IAIS is looking at a factor-based approach and in December 2013 launched the first of two consultations on the BCR. The second is scheduled to commence in July 2014 following the results of the March–June 2014 field-test.

The IAIS has developed principles to guide the development of the BCR. The three substantive principles are: that major risk categories should be considered; that there is comparability of outcomes across jurisdictions; and that the BCR has resilience to stresses. Within that core structure, proxy measures the valuation of will be selected and their factors calibrated. The proposed proxy measures for insurance liabilities and assets are the current estimates basis which are to be measured on the generally accepted accounting principles in each jurisdiction with some adjustments. The starting point for the BCR is the consolidated group-wide balance sheet, including non-insurance entities. Material off-balance sheet exposures also need to be considered. See box describing the BCR.

5. The IAIS is now calling this a basic capital requirement

BCR PROPOSED APPROACH

$$\text{BCR Adequacy Ratio} = \frac{\text{Qualifying capital resources}}{\text{Required capital}}$$

Required capital
- Factor-based approach
- Use proxies for underlying risks
  = Sum of (Liability factors multiplied by Liability measures)
  + (Sum of Asset factors multiplied by Asset measures)
  + (Sum of NTNI factors multiplied by NTNI measures)
  + (Sum of Other factors multiplied by Other measures)

- Qualifying capital resources
  = Capital resources +/- Adjustments

Source: BCR Consultation Document, IAIS December 16, 2013

The intended application of the BCR to G-SIIs needs to be revisited.

KPMG PERSPECTIVE

A number of issues raised in the first consultation relating to the overall design; the yield curve for discounting best estimates; segmentation; contract boundaries; and the overall approach requires further work.

The second consultation will address broader issues such as calibration; the relationship between the BCR and the group-wide capital requirement (insurance capital standard); whether the BCR will remain or whether it is a temporary measure; and how the BCR will be integrated into national and regional frameworks. The IAIS is also expected to make a decision later this year as to whether the BCR will apply only to G-SIIs or all internationally active insurance groups.

The broader issue for the IAIS and the industry is how many of these proposals for G-SIIs will eventually apply to all large groups and possibly to all insurers. In this regard, we have a number of observations concerning the developments of the BCR thus far:

- **The IAIS has not specified the level of capital that the BCR would be set against.** We believe that this will make it harder for participants to fully engage in discussions concerning the appropriateness of risk factor charges and overall design of the framework itself.

- **The intended application of the BCR to G-SIIs needs to be revisited.** The setting of a new minimum basic capital requirement for some of the world's largest insurance groups with no capital target level, at this stage, seems impractical. If the level of the BCR is set too low then in practice it is difficult to ascertain what value the requirement delivers to the overall supervision of these groups – especially as the G-SIIs themselves are each now operating under a defined minimum set of capital requirements from their home supervisor.

- **The BCR seems too simplistic a measure to apply to G-SIIs.** It is also not clear whether there will be any diversification credit allowed within the simple BCR matrix. It therefore seems unlikely that either these firms or their supervisors will accept the BCR as a good basis for capturing the risks run by these firms, or as a good basis from which to apply any capital surcharge to systemically important insurers.

- **It is not clear to what extent the BCR is being developed for reinsurers, given that a number of reinsurers could also be designated as G-SIIs.** While we recognize that these firms may also be participating in the Field Testing Task Force (FTTF) exercise, it would appear to be an omission that no mention is made of the possibility of the BCR's application to reinsurers. In this regard, the BCR factors should have due regard to the benefits derived from reinsurers and take into account the net exposure of positions rather than gross. Further explanation regarding the treatment of reinsurance is required.

- **The issue of market reaction to this new BCR remains unknown.** It is not clear from the IAIS discussion how the market is likely to respond to a BCR for a G-SII. Further analysis concerning this aspect would be beneficial e.g. what does a breach of the BCR mean in practice?

- **The IAIS will first have to identify the most appropriate valuation approach for the BCR.** Since the achievement of such a global standard has been difficult within the insurance sector, we would prefer to have seen this issue addressed first before undertaking the BCR itself. Given that a significant number of supervisors hold varying positions towards valuation issues, it remains to be seen how the BCR can fully proceed until such critical decisions are reached.

- **The IAIS has decided that the BCR should only include quantifiable measures by way of a risk-based factor model.** Such a basic framework could usefully be supplemented with strong Enterprise Risk Management (ERM) and governance requirements.

The IAIS has not specified the level of capital that the BCR would be set against. We believe that this will make it harder for participants to fully engage in discussions concerning the appropriateness of risk factor charges and overall design of the framework itself.

KPMG PERSPECTIVE

Given the State-based nature of supervision in the US, and lack of existing formal conglomerate or group-wide supervisory powers, there does appear to be a compelling need for a federal level of oversight capable of adequately assessing the group-wide risks of large insurance groups. Such a framework would additionally have the benefit of achieving global consistency with how IAIGs will be supervised by those countries outside the US – most whom are moving to conglomerate (group-wide) supervision. In the US, federal requirements could be facilitated by the current supervisory college process which is presently performed by State-based supervisors, and supplemented by model laws at the federal level, whereupon federal supervisors would also join the State-based supervisors in the supervisory college and general oversight of the insurance group.

US action

The impact the FSB's G-SII designation will have on the policy decisions in the home jurisdictions of the G-SIIs is of particular concern for many insurers.

In the US, the Federal Stability Oversight Council (FSOC) had identified three systemically risky non-bank companies: AIG, General Electric Capital Corporation, and Prudential Financial. A fourth company, MetLife, has been sent a letter indicating they are under review and Berkshire Hathaway (parent of General Re, GEICO and National Indemnity) has revealed that it has received a preliminary data request. If MetLife is designated, all three US groups named as G-SIIs will also be designated in the US.

The FSOC decisions on insurers have not been without controversy. Three members of the FSOC, including those with the most insurance knowledge, objected to the designation of Prudential Financial as systemically risky. One example cited that the analysis did not indicate that any other counterparty would be materially impaired because of losses resulting from exposure to Prudential. The dissents further criticize the overall methodology as failing to recognize the nature of the insurance business (i.e. how this differs to the banking model especially in regards to the pre-funding nature of insurance) and the authorities and tools available to insurance regulators.

FSOC's designation of these non-bank financial companies subjects them to supervision by the Board of Governors of the Federal Reserve System and to enhanced prudential standards. For each non-bank designee, a branch of the Federal Reserve Bank assumes responsibility as the consolidated supervisor of the group. This does not replace State supervision, but is added on top of it. The issue as to what capital requirements are to be imposed on the designees is still under debate. The Federal Reserve Board has indicated that it has some flexibility to tailor quantitative requirements for non-bank holding companies. In fact, legislation has been introduced in Congress that would exempt insurance companies from having to comply with bank risk-based and leverage capital standards.

Several insurers have publicly proposed suggestions for alternate approaches to capital. MetLife has been campaigning for a model which would use a capital ratio based on an aggregation of all legal entity reports. Others have looked at an insurance capital requirement based on the Basel capital rules. Prudential Financial has made such a proposal using a simple ratio which would measure the amount of financial resources available to absorb losses relative to insurance company assets.

In the US, the Treasury Department's Office of Financial Research is recommending that its financial data analysis office undertake a detailed study of the insurance sector to look at systemic risk issues and how these risks are handled by the current regulatory framework, the State system. The proposal raised the issue that regulatory arbitrage could be driving the organization of some parts of the industry; that leverage and illiquidity, as measured broadly, could be rising; and that the property/casualty insurance industry's cycle of hard and soft markets could fuel widespread failures of insurers and reinsurers.

European action

In Europe, the European Systemic Risk Board is working with the European Insurance and Occupational Pensions Authority (EIOPA) to develop ongoing data reporting for systemic risk purposes as the first reporting under Solvency II begins. In the meantime, as part of its consideration of the macro-economic environment, EIOPA conducted stress tests of insurers and pension funds and in July 2013 published its first half-year report on the financial stability of the insurance and institutions for occupational retirement provision sectors in the European Economic Area. EIOPA observed that the insurance and occupational pensions sectors are exposed to the risks of financial markets reversals, the impact of low interest rates and the weak economic fundamentals and outlook that characterize the risks to financial stability in the EU more generally.

In its December 2013 report on financial stability, EIOPA continued to point out that a prolonged low yield environment would pose a significant risk. In 2014, EIOPA plans to run a comprehensive stress test. It is envisaged that the protracted low interest rate environment will be a central part of this test.

On the investment side, EIOPA reported that exposure to sovereigns and financial institutions poses a varied challenge for entities that ranges from those experiencing very low yields on the sovereign holdings to others facing the risks of spread reversals on their higher yielding sovereign and bank exposures.

/ KPMG PERSPECTIVE

In addition, in the past year, the G20 has emphasized the importance of long-term financing for investment, including in infrastructure, in enhancing economic growth and job creation and asked the FSB to undertake diagnostic work to assess factors affecting long-term investment financing. We support this analysis, especially with regards to identifying the important role insurers play in the provision of such investment.

IAIS macro-prudential surveillance activities

In parallel to the work toward identifying potential G-SIIs, the IAIS has developed a framework for Macro-prudential Policy and Surveillance (MPS) in insurance. This work builds on the foundation laid down in the Insurance Core Principles (ICPs) approved in October 2011, and in particular on ICP 24, which provides the principles and standards for macro-prudential surveillance to be implemented by the appropriate authorities.

In contrast to micro-prudential supervision, which is concerned with the viability of individual institutions, macro-prudential surveillance focuses on enhancing the supervisory (or relevant regulatory body) capacity to identify, assess and mitigate macro-financial vulnerabilities. The financial crisis demonstrated the critical absence of effective mechanisms to monitor the growing complexity and opacity of financial institutions and assess the extent of cross-border exposures. The IAIS is encouraging the development and enhancement of supervisory capacity to identify, assess and mitigate macro-financial vulnerabilities.

The IAIS plans to refine the macro-prudential surveillance framework by issuing guidance on the practical application of related IAIS Insurance Core Principles and by developing a toolkit and data template of early warning risk measures to be leveraged for stress testing. It will also determine key indicators of general macro-financial vulnerabilities; design a conceptual approach for defining risk transmission; and developing a macro-prudential framework for individual jurisdictions. This could later include guidance on the setting of national powers and tools required. These steps are outlined in a July 2013 report from the IAIS, *Macro-prudential Policy and Surveillance in Insurance*[6].

One of the issues the IAIS faces in this work is the limitation on its role as a data collector since the IAIS is structured as an association and as a result has few confidentiality protections. The Organization for Economic Co-operation and Development (OECD), which currently collects and analyzes insurance data, has been exploring the possibility of using the OECD's Global Insurance Statistics Framework as a resource for macro-prudential authorities and the FSB. As a start to that project, the OECD Insurance and Private Pensions Committee will begin a stocktaking and review of data analysis tools across countries. The project will ultimately lead to an identification of data gaps which need to be addressed.

An Inter-agency Group on Economic and Financial Statistics, comprised of the BIS, ECB, Eurostat, IMF, OECD, UN and World Bank, is consulting with the FSB on ways to address these gaps as outlined in a report to the G20 entitled, *The Financial Crisis and Information Gaps*[7].

Given the State-based nature of supervision in the US, and lack of existing formal conglomerate or group-wide supervisory powers, there does appear to be a compelling need for a federal level of oversight capable of adequately assessing the group-wide risks of large insurance groups.

6. IAIS, July 18, 2013. http://www.iaisweb.org/G-SIIs-988
7. The Financial Crisis and Information Gaps, Report to the G20 Finance Ministers and Central Bank Governors, prepared by the IMF staff and the FSB Secretariat, October 29, 2009. http://www.imf.org/external/np/g20/pdf/102909.pdf

Americas perspective

Reform of insurance regulation continues to sweep across the Americas, fueled in part by recent assessments of the financial markets based on the IAIS core principles, adoption of IFRS standards for accounting, and the desire in some jurisdictions for equivalence with Europe. The recent changes generally increase the risk-focused nature of regulation, strengthen the independence of the supervisor, enhance consumer protection and disclosures, and improve corporate governance requirements for insurers.

This report has highlighted the role of the Financial Stability Board (FSB) reviews, the financial sector assessment programs being conducted by the IMF and the IAIS peer review program in stimulating reforms. These reviews have definitely had an impact on the Americas region, but for North America another pending review process looms over the reform movement. The countries in North America are at the center of equivalence considerations in Europe and each nation is taking a separate approach to the question as to whether to apply for equivalence.

Bermuda and Canada are the two extremes in the process. Canada has declined to apply for equivalence, saying that one jurisdiction should not evaluate another and pushing for a more global process. This position prompted a legislative change in the Solvency II equivalence provisions to allow an equivalence decision as it relates to EU companies even in the absence of a third-country country's application. Bermuda, on the other hand, was one of the first countries to apply for full equivalence and has been working hard to implement a solvency regime that will meet the criteria set by the Commission and EIOPA. Mexico, Brazil and Chile have recently applied for temporary equivalence and the US is seeking a unique solution for itself through the EU-US Dialogue process. The Commission has indicated it will begin to make its decisions on equivalence in early 2015. At stake is: market place access for third country insurers; recognition of third country group supervision; and some relief from the higher Solvency II capital requirements for EU based international writers.

Added to these considerations are pressures on Bermuda, Canada, and the US because of the number of internationally active insurance groups based in those countries. Any changes made by the IAIS to move to a global capital standard or to impose special requirements on globally systemic insurers will fall to the supervisors in these regions to implement. One concern for insurers in this region is whether these new requirements will apply to all insurers in order to provide a level playing field. This concern is particularly relevant in the US where there are many large players with little or no international business.

A summary of the areas of significant reforms is now provided:

Solvency Regulation: Perhaps the most dramatic changes in the Americas are occurring in changes to risk evaluation and the inclusion of new risks in the assessment of insurer solvency. Although some of the reforms closely follow the Solvency II three pillar approach, even those that don't are explicitly identifying market, credit, and operational risk in their calculations.

There is also a greater emphasis on the insurers own risk management. The US, Canada, Mexico, and Bermuda will now all require companies to report their own risk self-assessment (ORSAs). The use of internal models for solvency regulation has been slow in the region, although both Bermuda and Canada are exploring their use in setting capital requirements.

As the adoption of IFRS in Mexico, Canada, and parts of Latin America grows, so does the shift towards market consistent valuation although financial stresses in parts of South America may slow these developments. In Brazil and Argentina there are increasing limits on foreign reinsurance and a role back of the reforms of a few years ago. On the other hand, the weakness of State pensions is stimulating a push for private market solutions in Argentina as it did in Chile.

Corporate Governance and Disclosure: New regulations defining more clearly the responsibilities and scope of the insurance company board and management and requiring disclosure of financial information have been adopted around the region in response to international standards in the area.

Consumer Protection: Market conduct laws and consumer protection policies have been expanded in Latin America, Mexico, and Canada. These changes are driven in part by the strong push by the IMF for more proactive monitoring of consumer issues, on-site inspections of claims handling practices, and controls on the appropriateness of products and selling practices of intermediaries.

Supervisory structure: The IAIS core principles stress the need for an independent supervisory authority. In the Latin American countries recent legislation has expanded the powers of the regulators in Mexico, Chile and Argentina.

Captives: The use of captive insurers, especially in the life insurance area, is of growing concern in the US and we may see more limits across the region on captive insurers in the coming year.

Groups: Group supervision has been a greater issue in North America where many international insurance groups are based. As an integrated supervisor, the Canadian Office of Superintendent of Financial Institutions (OSFI) is already a consolidated supervisor and for several years has been capturing information of worldwide activities. Bermuda is now implementing the final pieces of its own group supervisory structure with the application of the group capital requirement (BSCR). This issue, though, is still under debate in the United States because of the State-based nature of regulation. While the NAIC has increased the powers of the lead supervisor over groups through the changes to the Model Holding Company Act, these changes have so far only been adopted in half the States. Although these changes give State regulators the power to collect data on global business and non-insurance entities, they do not provide authority to impose a group capital requirement and there is no requirement for a consolidated group statutory accounting report.

To fill this gap, other US regulators are expanding into the insurance area. The Federal Reserve Bank now has consolidated supervisory authority over what some believe is nearly a third of the insurance premiums in the US through its power under the Dodd-Frank Act to regulate any insurance holding company with a federally charted thrift institution and any insurer designated as systemically important by the Financial Stability Oversight Committee (FSOC). The Federal Reserve is currently debating what capital requirement to impose on these groups, although there does seem to be recognition that these requirements should not just copy the banking standards.

The Federal Insurance Office (FIO) has no direct authority to regulate insurance unless it proves a case that federal regulation is necessary to eliminate regulatory arbitrage. In its long awaited Modernization Report, the FIO pushes for greater harmonization and the use of supervisory colleges to overcome the shortcomings of solo entity supervision in the US, but does not suggest more radical reform. It does ask for the authority to participate in the supervisory colleges of large nationally and internationally active insurers.

ARGENTINA

Despite the second consecutive year of deceleration in Argentina, the insurance market maintained its trend of expansion, though to a lower extent than that evidenced in 2012.

The last fiscal year was influenced by the strong losses caused by some of the most severe weather conditions experienced in the last few decades (floods, droughts and hailstorms). Notwithstanding, financial gains still offset technical losses, even to a higher extent that of prior years. Pursuant to the data provided by the local regulator (Superintendencia de Seguros de la Nación –SSN), the lines with the highest impact on the increase in production during 2013 relate to automobile, workers' compensation and agricultural insurance lines. The automobile line still has the highest impact as a result of the increase in the automobile fleet while the increase in the workers' compensation insurance segment is due to the increase in salaries as a consequence of the inflationary trend mentioned before. Furthermore, the growth in the agricultural line is related to the expansion of the sown area, though during this year strong losses were observed in this business as a result of the adverse weather conditions described above.

As opposed to 2012, in 2013 there were no substantial changes in regulations having an impact on the industry in general. The changes in regulations are related to higher minimum capital requirements and a gradual reinforcement in the calculation of reserves involving insurers and reinsurers.

Regarding the reinsurance regime reform introduced in 2012 (which led to the creation of a local reinsurance market), in 2013 the consolidation phase began. Companies operating:

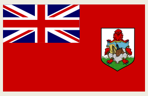
- 9 companies that are Argentine branches of foreign companies,
- 19 companies that have been organized in the country, and
- 5 insurers authorized to conduct reinsurance operations.

It should be noted that some of the companies of the first two groups do business as captive companies (i.e. they provide insurance only to insurers belonging to their own business groups).

2014 market expectations are as follows:

- Due to the growing technical loss experienced in fiscal year 2013, as against the prior year, companies are expected to continue applying strong costs and expenses control policies as a way to mitigate the inability of transferring the total inflation effects to their fees.
- In the short run, financial results are expected to increase as a response to increases in the quotations of local investments made in government bonds and leading companies' shares, and as a need to cover the technical looses suffered.
- Cars: premiums will increase as a result of the continuously growing number of cars in the market and of increases in the price of both new and used cars.
- Work risks: they will continue to increase jointly with salary increases fuelled by inflation.

BERMUDA



The Bermuda market for insurance is comprised of several distinct markets: large international reinsurers, captives and special purpose insurers. Each sector has a unique regulatory structure, although all fall under the auspices of the Bermuda Monetary Authority (the BMA).

In 2014, the Authority will continue to embed progressive framework enhancements throughout Bermuda's insurance regimes at a pace that is appropriate for the firms operating in the local market.

In 2013, the BMA was invited to participate in an expedited assessment for the National Association of Insurance Commissioners' (NAIC) Qualified Jurisdiction process. This process, developed to evaluate the reinsurance supervisory systems of non-US jurisdictions for reinsurance collateral reduction purposes, resulted in Bermuda being one of four jurisdictions to be granted qualified jurisdiction status at the end of 2013. There is already direct benefit to Bermuda-based reinsurers to be derived from achieving this status, and the BMA will participate in the full NAIC Qualified Jurisdiction assessment in 2014.

The BMA continues to monitor developments in relation to Europe's Solvency II Directive. EIOPA's equivalence assessment of Bermuda for Solvency II found the regulatory framework for commercial (re)insurers to be largely equivalent with the Directive. That position remains in place. EIOPA's subsequent confirmation that they have the ability to grant 'bifurcated' equivalence also still stands. This means Bermuda's regime for captives can remain out of scope for final equivalence confirmation, placing Bermuda in an ideal position given the nature of its market. The BMA has also confirmed that it will not apply any Solvency II-type regime to Bermuda captives.

Group supervision

Group supervision has been in effect and implemented on a phased basis for Bermuda's largest insurance groups since 2011. The BMA will continue the roll out of the framework in 2014, extending group supervision to groups where the Designated Insurer will be Class C, D, E and 3A insurers.

In addition, having concluded a market consultation last year, the BMA will implement group capital requirements in 2014. This requirement will apply for 2013 year-end financial reporting and will be phased in over a five-year period. The Authority has established a revised BSCR for application to insurance groups in order to assess regulatory capital requirements for such entities. However, insurance groups will also have the option to apply to have their required regulatory capital calculated via their own internal models.

The BMA's schedule of supervisory colleges will also continue throughout 2014. They will both participate in colleges and host such sessions, in the latter case in relation to groups for which the BMA is Group Supervisor.

Long-term insurer regime

The major element of work to bring Bermuda's Long-Term insurers within scope of the BMA's enhanced risk-based solvency framework is now complete. The BMA's modified BSCR, specifically tailored to account for the particular risk characteristics of life (re)insurers, and incorporating valuable input from extensive market consultation, will take effect in 2014 for commercial Long-Term firms (Class C, D, and E). This will be the first year of a three-year phased implementation for this sector, enabling the market to make necessary adjustments as they transition to the full enhanced capital requirement.

Internal Capital Models (ICM)

The BMA began accepting ICM applications in 2013, and will continue to review submissions received throughout 2014, for both General Business and Long-Term insurers and Groups. In addition, to build on the in-house skills and knowledge, the BMA will assess capabilities and capacity to review internal models for other segments of Bermuda's financial services sector.

The BMA plans to progress its position on an economic balance sheet for commercial insurers by continuing discussions with the respective industry associations and monitoring ongoing developments at international standard-setters, i.e. the Financial Accounting Standards Board and International Accounting Standards Board.

BRAZIL

The Brazilian Insurance market and insurance regulator (SUSEP) continue to refine and update the regulations for the industry. Insurance is growing at a much more significant pace than the overall economy, and SUSEP is keen to translate international developments, when considered relevant and adequate, into Brazilian supervisory regulation. Furthermore, changing tax regulations continue to have an impact on the wider economy as well as on the insurance industry.

When looking back at 2013 and ahead at 2014 and beyond, the most important elements of the regulatory agenda for the insurance industry are the following:

Solvency regulations
SUSEP has decided not to implement Solvency II as a framework, however, it is implementing the rules and directives required to manage each risk category individually and has recently sought Solvency II equivalence. Up to now, SUSEP has already issued directives relating to insurance risk, credit risk and market risk management. Market risk is going to enter solvency calculations starting 2014, and the impact is expected to be significant. Operational Risk management has been extensively discussed in the market place and the issuing of its regulation is expected for the end of 2014.

Liquidity regulations
In December 2013, SUSEP issued a regulation under which insurance companies are required to maintain a larger liquidity buffer. The liquidity requirement is based on a percentage of available capital, whereby certain assets that are already linked to insurance liabilities are excluded. This will require careful inclusion in monthly liquidity forecasting for insurers.

LAT surplus reflected in accounting records
Late 2012, SUSEP issued additional regulation on the calculation of the Liability Adequacy Test in order to increase consistency in calculations between insurers. Where these new calculations resulted in a surplus at 1 January 2013, the regulation requires insurers to release this surplus to the profit and loss account by December 2014 at the latest.

Transitory tax regime after IFRS conversion replaced
In 2008, Brazil adopted IFRS accounting principles for accounting purposes. For tax purposes, Brazilian companies continued to calculate their corporate income tax according to Brazilian GAAP principles in force as at 31 December 2007. In November 2013, the tax authorities enacted a so-called Provisional measure that governs the application of IFRS accounting rules in the corporate income tax calculations. As a general rule, provisions apply from January 1, 2015, but Brazilian tax payers should apply these rules starting 1 January 2014. This has created some controversy, specifically in respect of (i) the tax treatment of dividend payments of equity accumulated during the transitory period and (ii) the tax treatment of goodwill. These and some other aspects are still being discussed. The final approval of the regulations, potentially including some further refinements, is expected in April 2014.

Obligatory external actuarial certification on the horizon
During 2013, draft regulation was issued that seeks to oblige insurance companies to obtain external actuarial certification of the technical reserves on a yearly basis, starting in the financial year 2014. Discussions on the formal as well as the practical application of such requirements are still being held. Final regulations are expected to be issued in March 2014.

FSAP
Brazil underwent an IMF financial sector assessment in early 2012. Brazil was praised for improvements to the solvency requirements, disclosure rules, consumer protection, and anti-fraud provisions. The findings indicated a need to improve the corporate governance, consumer information, international cooperation agreements, group supervision, the political independence of the supervisor, and the openness of the reinsurance market.

Equivalence
Brazil has now applied for temporary equivalence under Solvency II.

CANADA

Canadian insurance regulators continue to strengthen local regulatory practices and align even more closely with the IAIS's Insurance Core Principles (ICPs). While Canada is not adopting Solvency II or seeking recognition of equivalence, the Canadian regulatory system already has many elements in common with Solvency II as a result of aligning with the ICPs.

Regulatory solvency capital and risk management
The influence of the ICPs was reflected in the following key initiatives of the Federal Office of the Superintendent of Financial Institutions (OSFI):

- In January 2013, OSFI issued its final Guideline – Corporate Governance of Federally Regulated Financial Institutions, to be effective and implemented by the end of 2013. The Guideline includes significant enhancements related to governance and risk oversight, such as board risk committees, chief risk officers, and periodic validation of governance and risk practices. These requirements have naturally led to concerns about scalability for smaller insurers. OSFI has stated that there are no "bright lines" for these requirements, and that implementation is subject to the nature, scale and complexity of the insurer. While this leaves some scope for insurers in implementation, regulators will need to be satisfied that the governance objectives have been met.
- In November 2013, OSFI issued its final guideline for Own Risk and Solvency Assessment (ORSA). The new ORSA requirement is very similar to the ORSA under Solvency II and has been introduced relatively swiftly, effective for 2014, ahead of many other jurisdictions. An ORSA will be required for all insurance corporations supervised by OSFI, and also branches of foreign insurance companies – many of which will not previously have completed an ORSA in their home jurisdiction.
- Canadian regulatory capital requirements continue to evolve, with active consultation processes between OSFI and industry participants, and a series of QISs (Quantitative Impact Studies) for both life and non-life insurers. The current regulatory capital system is essentially a 'standard' model with certain risk elements not explicitly measured, such as operational risk and credit for diversification. However, the path forward is clearly to incorporate these elements, as reflected in OSFI's November 2013 update of its Life Insurance Regulatory Framework (LIRF). Internal models are to be available for use for life insurance segregated fund capital requirements in 2016, with a longer term project to consider the broader use of internal models for other life insurance risks as well. Acceptance of internal capital models by regulators appears likely to be gradual.

The influence of international standards developments, driven by the Insurance Core Principles, has not stopped with corporate governance, risk management and capital regulation. The ICPs related to insurers' conduct of business with customers and the use of intermediaries are also affecting market conduct regulation. Provincial financial service regulators are responsible for market conduct by insurers, and are showing greater interest in the OECD concepts of Treating Customers Fairly and Customer Outcomes. This appears likely to lead to a more demanding market compliance environment for Canadian insurers, including a need for a robust conduct risk framework.

Auto insurance continues to be a hot spot for regulators, insurers and consumers, with consumer concerns over affordability coupled with insurer concerns over controlling claims costs, including reducing their exposure to fraudulent claims.

CHILE

During the last two years the insurance industry has experienced significant regulatory changes. Firstly, the implementation of IFRS introduced a new accounting framework which is in line with international standards. Without doubt this represented a major benefit for the sector, since it brought a considerable improvement in terms of the information disclosed and analyzed by different market agents. The financial statements as of 2013 will be presented in a comparative form unlike those released in 2012 the transition year. Secondly, the local regulator has focused on the improvement of the existing Corporate Governance structures, which resulted in developing new principles and practices, emphasizing the role and responsibilities of the Board of Directors. Finally, the local regulator issued a standard that aims to improve the risk management process in the insurance sector, which is aligned with the new risk-based supervision model led by the Superintendencia de Valores y Seguros (SVS).

Insurance contracts
In May 2013, the Law 20.667 was published which has as its main objective to upgrade the legal regulation associated with insurance contracts, incorporating all aspects related to the commercialization of these contracts. This includes a change in the existing insurance policies, which strengthens policyholders' rights. This means greater scope over the contracts that are taken out, and also it criminalizes fraud intent. Additionally, the introduction of this law will aid the supervision and monitoring process of the rights and liabilities of all parties acting in the market. This new provision has been in force since December 2013.

Risk-based capital
In January 2013, the SVS issued the first exposure draft with methodology that will be used by the insurance sector to quantify the Risk-Based Capital. To date, the industry has conducted a first exercise applying such methodology. The outcomes of this exercise are being analyzed by the local regulator. In 2014, it is expected that the SVS will release the official White Paper with the guidelines to quantify the Risk-Based Capital.

Securities and exchange commission
Currently, a bill is being discussed in the Chilean Parliament which aims to transform the actual Superintendencia de Valores y Seguros in a Securities and Exchange Commission. The main purpose of this initiative is the foundation of an autonomous and independent entity, through the introduction of new regulatory standards and institutional transparency.

Equivalence
Chile has applied for temporary equivalence under Solvency II.

MEXICO

The Mexican legal framework for insurance was overhauled in 2013 with the adoption of Ley de Instituciones de Seguros y Fianzas, LISF. Its promulgation toughens capital requirements and brings Mexico's supervisory system in line with other risk focused regimes such as Solvency II. The law is expected to enter into force in 2015.

The new Mexican solvency regime incorporates the three pillar scheme of the EU Solvency II Directive: Pillar I deals with all the quantitative requirements; Pillar II considers the different qualitative requirements in the operation of an insurance undertaking (corporate governance, risk management, actuarial function, and internal audit and control), as well as the issues regarding the supervisory process; and Pillar III establishes requirements on transparency, disclosure and market discipline.

Technical provisions
The law introduces a market-consistent valuation of technical provisions. As in the Solvency II Directive, the value of technical provisions shall be equal to the sum of a best estimate and a risk margin. Additionally, the new regulation also establishes a precise definition of the responsibility of the board of directors and managers regarding the adequacy of technical provisions.

Solvency Capital Requirement (SCR)
The law allows insurance undertakings to calculate the SCR by using either the standard formula or their own internal models. The latter will be subject to the approval of the supervisory authority. The application must demonstrate that the internal model meets the use test and the statistical quality, calibration, validation and documentation requirements established by the regulation. Both mechanisms for the calculation of the SCR should include an assessment of capital requirements by risk categories (underwriting, market, spread, credit, liquidity, concentration and operational risks), and their interactions, based on a 99.5 percent confidence level over a one-year horizon. Eligible Own Funds (EOF), considering their quantity and quality, should be sufficient to cover the SCR. Insurance undertakings should perform stress tests at least once a year, for the purpose of evaluating the sufficiency of the funds to cover the SCR under different feasible adverse scenarios.

Investment policy
The insurance law provides that insurers must carry out their investment activity according to an investment policy approved by the board of directors and managers. The investment policy shall consider asset-liability matching, be consistent with the nature, duration and currency of the liabilities, and maintain appropriate liquidity levels. Insurance undertakings must have in place an effective risk management system that consists of strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis, the risks of their investments at individual and aggregated levels.

Reinsurance
The law maintains the current indirect mechanism to supervise reinsurance operations. Foreign reinsurers who operate in the Mexican market must be listed in the General Register.

Corporate governance
The insurance law enhances corporate governance practices, establishing a clear definition of the responsibility of the board of directors and managers regarding the operation of an insurance undertaking. Insurers' systems of corporate governance must include the risk-management function, the internal control function, the internal audit function, the actuarial function, and surveillance of outsourcing activities.

Risk management
Insurance undertakings must have in place an effective risk management system comprising policies, strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis, the risks to which they are or could be exposed at individual and aggregated levels, and their interdependencies. As part of their risk-management system, insurance undertakings shall conduct their Own Risk and Solvency Assessment (ORSA).

Disclosures
Regarding elements considered in Pillar III, the draft Insurance Law contains a clear definition of the requirements regarding disclosure of information to the market, which are consistent with the features of the new regulatory regime. Insurance undertakings will have to issue, on an annual basis, a Solvency and Financial Condition Report (SFCR) that sets out the information that is to be publicly disclosed.

Supervisory process
In terms of control and surveillance of insurance undertakings, the project amends the supervisory powers of the Insurance and Surety National Commission (CNSF) to make them consistent with the nature of the new regulatory framework. In order to integrate the supervisory cycle (from licensing to winding up), the project establishes that a number of functions that are currently carried out by the Ministry of Finance are to be transferred to the CNSF.

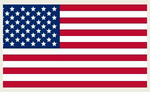
Compliance with the IAIS principles
The 2012 IMF assessment indicated Mexico shows a high level of compliance with IAIS core principles.[8] The new law should increase that compliance score.

Supervisory authority
The IMF assessment did note some concerns with the insurance supervisor, CNSF, including a lack of independence, budget autonomy, and a drain of expertise in the department. However, the report emphasizes that transparent processes and an open dialogue with the industry have created the positive reputation of the agency.

Equivalence
Mexico is a candidate for temporary equivalence under Solvency II. A decision is expected in 2015.

8. The FSAP, conducted in September 2011, was based on the older version of the ICPs.

USA



The structure of insurance regulation in the United States is changing dramatically as the Dodd-Frank Act provisions are implemented. Although the current Administration remains committed to State-based regulation of insurance, an increasing percentage of the insurance business is now subject to consolidated Federal regulation at the holding company level. In the next year, the balance of power among the Federal Reserve, Federal Insurance Office (FIO), and the National Association of Insurance Commissioners (NAIC) may shift considerably.

Federal reserve system
Thus far the Financial Stability Oversight Committee (FSOC) established by the Dodd-Frank Act has identified AIG and Prudential Financial as systemically important, placing them under supervision of the Federal Reserve. MetLife may be similarly designated in 2014. In addition, insurance holding companies that operate federally chartered thrift institutions are also subject to oversight including State Farm and other large personal lines insurers. The Federal Reserve is expected to set capital requirements for non-bank institutions in the coming months. Although multiple proposals are being reviewed, it is likely that the requirements will be influenced by the Basel III standards. The insurers subject to these new requirements have already raised concerns about a level competitive playing field in the US if other large insurers have lower capital standards. Depending upon the final shape of the requirements, it is possible some companies, which have long wanted optional federal regulation, might see the Federal Reserve as a way to achieve more unified regulation and to avoid onerous State-based rate regulation.

Federal Insurance Office (FIO)
Although the FIO is not directly a supervisor, the Dodd-Frank Act did give it authority to examine Federal regulation of certain lines of insurance and the need for Federal regulation to eliminate or minimize regulatory arbitrage. In December 2013, the FIO released its report, *How to Modernize and Improve the System of Insurance Regulation in the United States*[9], which recommends a number of areas for FIO involvement, including mortgage insurance, covered agreements for reinsurance collateral requirements, engagement in supervisory colleges, broker licensing, and pilot programs for rate regulation.
The report focuses on the role of the FIO and its recommendations for near-term improvement to the insurance regulatory system in the US. Regulatory items not related to solvency and financial reporting (e.g., market conduct and the mechanics of dealing with insolvent insurers) are not examined in detail.

Main findings from the FIO report
The FIO does not recommend that State insurance regulators be replaced wholesale by a single federal regulator. The Report prefers a more dissective two-part approach. One part is identifying areas where federal intervention is warranted. The second is to recommend short-term changes to the current State-based regulatory system. Cooperation between States, and between countries, to pool knowledge and resources across States and across countries, is a recurring theme.

The Report reiterated the limitations of the current State-based insurance regulation in the US, in particular:
- Higher cost of regulation per dollar of premium;
- Uniformity and consistency issues; and
- Lack of coverage of non-US players (especially in reinsurance).

It also recognized the local nature of some insurance products (not necessarily relevant to life or health insurance), where State regulation would be more appropriate.

The Report concludes that the proper question is not whether there should be federal or State regulation, rather whether the better question is to explore if there are areas in which federal involvement is warranted, and, if so, which areas. The report outlines that the necessity for federal involvement in any area should be based on:
- The ability of the States to regulate that area effectively;
- The ability of the States to regulate that area with uniformity;
- The degree of national/federal interest for that area; and
- The connection of the issues and the firms with the global marketplace most impacted.

Essentially the report finds that if the answer is that federal involvement is warranted, the next question is what form that involvement should take. Some possibilities are:
- Direct regulation;
- Standard setting; and
- Operating a program to support or replace a failed insurance market.

Specific, short-term reform recommendations for the States
Based on the above framework, the Report recommends the following to improve and modernize the US system of insurance regulation:

1. For material solvency oversight decisions, a process where the appropriate State regulator must obtain the consent of regulators from other States in which the subject insurer operates.
2. An independent third-party review mechanism for the NAIC Financial Regulation Standards Accreditation Program.
3. A uniform and transparent oversight regime for the transfer or risk to reinsurance captives.
4. Convergence of State oversight and capital adequacy regimes to best practices and uniformity.
5. Moving forward cautiously with Principles-Based Reserving (PBR), with (a) consistent, binding guidelines for accounting and solvency requirements, and (b) uniform guidelines and sufficient resources at the State level to ensure adequate supervisory review of PBR.
6. Development of State corporate governance principles for corporate directors and officers, appropriate to the size and complexity of the insurer.
7. Continue to develop an approach to group supervision to address the shortcomings of solo entity supervision. In particular, consider the concept of supervisory colleges[10].

The Report goes on to recommend uniform approaches to (a) State guarantee maximum benefits, and (b) the administration of estates of failed companies, especially the settlement of qualified contracts with counterparties. It also makes a number of recommendations for market conduct issues.

9. The full report can be found at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf
10. Supervisory colleges are meetings of insurance regulators in different jurisdictions where the topic of discussion is regulatory oversight of one specific insurance group that writes significant amounts of insurance in many jurisdictions (see NAIC Center for Insurance Policy and Research, July 2012 newsletter). The IAIS is seeking to improve the operation and efficiency of supervisory colleges globally, as part of their Common Framework Project (ComFrame).

Recommended areas for direct federal involvement

The Report lists a number of areas where federal involvement is recommended, or may be recommended near-term. Items 2 and 3 are relevant to solvency regulation for the life and health insurance industries:

1. Develop federal standards for mortgage insurer oversight.
2. Pursue a covered agreement on reinsurance collateral requirements based on the NAIC Credit for Reinsurance Model Law and Regulation.
3. Engage in supervisory colleges to monitor large national and internationally active insurers
4. National Association of Registered Agents and Brokers (NARAB) Reform Act should be adopted and the FIO should be charged with monitoring its implementation.
5. Develop personal auto insurance policies for US military personnel enforceable across State lines.
6. Establish pilot programs for rate regulation that maximize the number of insurers offering personal lines products.
7. Report on the manner in which personal information is used for insurance pricing and coverage.
8. Identify ways to increase access and affordability of insurance to Native Americans.
9. Monitor the simplification of surplus line tax collection; determine if federal action may be warranted.

Other Sections of the Report included:

- A history of US insurance industry regulation, including the financial crisis, AIG, government support for the industry, and lessons learned;
- A discussion of prudential oversight – the entire framework of capital requirements, accounting standards, investment portfolio limitations, practices to promote the safety and soundness of insurers, State guaranty funds, and the process for resolving insurer insolvencies. This section also serves as a 'basis for conclusions', showing the analysis that led to the recommendations and conclusions; and
- A discussion of marketplace oversight: consumer protection and access to insurance.

In the next year, the balance of power among the Federal Reserve, Federal Insurance Office (FIO), and the National Association of Insurance Commissioners (NAIC) may shift considerably.

FEDERAL INSURANCE OFFICE (FIO) RESPONSIBILITIES

The FIO, formed in July 2010 as part of the Dodd-Frank act, was given the following authorities:

- Monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the US financial system;
- Monitor the extent to which traditionally underserved communities and consumers, minorities, and low / moderate-income persons have access to affordable insurance products for all lines except health insurance;
- Recommend which insurers, including affiliates, should be designated as non-bank financial companies to be supervised by the Federal Reserve;
- Assist the Treasury department in administering the Terrorism Insurance Program established in 2002;
- Coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, including representing the US in the IAIS and assisting the Secretary in negotiating covered agreements[11];
- Determine whether State insurance measures are pre-empted by covered agreements;
- Consult with the State insurance regulators regarding insurance matters of national importance and prudential insurance matters of international importance; and
- Perform other related duties and authorities as assigned.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

The NAIC has certainly pushed back against growing federal involvement in insurance, both politically and through extensive reforms to its solvency system, generally described as the Solvency Modernization Initiative (SMI). The NAIC has just completed this five-year project and issued a summary report on the progress achieved. Although the changes in the NAIC Model laws and procedures are significant, the implementation at the State level has been slow. The main leverage the NAIC has for adoption is the accreditation process, a procedure by which States are regularly assessed to ensure that they adopt and implement NAIC model acts and regulations. This process may become stricter since the FIO Modernization report is recommending independent third party oversight of these reviews to assure 'appropriate and objective rigor'.[12]

Group supervision

The broadest criticism of the State insurance system has been aimed at the lack of group-wide supervision. The NAIC responded early to this challenge by adopting changes to the Model Holding Company Act and by holding supervisory colleges for the insurers with substantial international business. Nearly half the States have adopted the 2010 Model Act changes, which provide States with the authority to examine the holding company and require reporting of data on global business. It provides indirect authority over non-insurance entities within the holding company to the extent they might impact the insurance entities. The NAIC is also adding guidance to the Financial Analysis Handbook to address group-wide supervision and the roles and responsibilities of the group-wide supervisor. The Act does not impose a group capital requirement, but there is active debate within the NAIC as to how such a requirement might be implemented in a State based regulatory system if the IAIS develops a group capital standard. The complexity of this task will be increased because the IASB and FASB have failed to converge on insurance accounting standards so far.

→ ORSA

The NAIC has completed its second pilot project on ORSA and plans to conduct a third test in 2014. Fourteen insurance groups participated in 2012 and 22 in 2013. The NAIC ORSA subgroup has indicated that the quality of reports improved between the first and second pilot. The subgroup issued a summary of its findings from the second pilot, but has indicated that none necessitate changes to the ORSA Guidance Manual. The subgroup may clarify the 'in use' requirement that the ORSA be used by the Board in making decisions not just developed for the regulator. Some of these suggestions to insurers were to include:

- a table of contents and executive summary;
- to map legal entities to business units;
- to include a more detailed explanation of risk limits and to identify recent changes;
- to discuss prospective risks;
- to discuss risk mitigation;
- to perform combined stress scenarios in addition to single stresses and to include more liquidity stresses;
- to expand the explanations as to how capital models are calculated and to include a graph comparing various models if different models are used;
- to include a flow chart of the ERM control functions;
- to include an explanation as to how compensation and incentives are linked to risk management; and
- to include heat maps to identify key risks and to rank risks by materiality.

States will require an ORSA to be filed beginning in 2015, although so far only seven States have adopted the model act. Insurers will be required to submit a group-wide ORSA including stress testing, economic valuation, and details on risk management policies and practices.

→ Corporate governance

The NAIC has developed specific insurance corporate governance requirements in response to criticisms by the International Monetary Fund in its assessment that there are no model laws addressing this area. The NAIC has developed a model law, which calls for additional disclosures, internal audits and a common exam assessment of corporate governance. In addition, the FIO report has urged the NAIC to adopt character and fitness expectations on directors and officers.

➔ Reinsurance

The NAIC has been very successful in implementing changes to the credit for reinsurance system in the US. Most of the large States have adopted the law necessary to reduce collateral requirements for unauthorized reinsurers and to allow reinsurers to operate on a passporting basis as allowed by the Nonadmitted and Reinsurance Reform Act (NRRA). In order to qualify, a reinsurer must be certified as coming from a 'qualified' jurisdiction. The NAIC has now recognized four foreign jurisdictions (Bermuda, Germany, Switzerland, and the UK) as conditionally qualified and will consider three more in 2014. However, concerns remain regarding inconsistent application of the program and the use of credit rating agencies in the financial assessment. The FIO has said it will pursue covered agreements to resolve reinsurance collateral issues. These issues are particularly important in regard to the European Union, possibly affecting whether the US will be recognized as equivalent. With Bermuda, Switzerland and Japan on track for equivalence recognition, a positive solution remains important to US reinsurers.

Risk-based capital

One major criticism of the US risk-based capital requirements has been the need to update the 25 year-old system to create more consistent calibration of risks and to add risks that were not explicitly identified. Going forward, regulators expect to recommend that every evaluation of formula factors for individual risks that is grounded in credible historical data be supported, where possible, by an underlying safety level and time horizon. The NAIC is also completing work that would add operational and catastrophe risk charges, probably by 2015. The FIO report further recommends convergence to best practices and uniform standards by requiring agreement by other supervisors before implementing discretionary practices in accounting or capital standards.

➔ Principles-Based Reserving (PBR)

One of the significant changes has been the adopting of a new principles-based reserving (PBR) system for life insurance, but adoption of these changes by the States has begun slowly. At the end of 2013 only seven States have adopted the standard valuation model law. 42 States, representing 75 percent of the nationwide premium volume, must adopt it for the law to go into effect. The new system would rely upon an insurer's internal risk modelling and analysis techniques to calculate reserves. There remain extensive concerns about the regulatory resources need by the States to evaluate the reserve models within companies. The FIO report has called for oversight of vendors who would provide such services to the States.

➔ Use of captives

In the past two years the use of captive insurance programs in the US has come under increased scrutiny as to their use for capital arbitrage by life insurers. The NAIC has been studying the issue since 2011, and released a white paper in 2013, and a recommended policy will be considered this year. The FIO Modernization report recommended the States develop a uniform and robust solvency and oversight regime for the transfer of risks to reinsurance captives or special purpose vehicles.

➔ Creating a national market

Increasing consumer pressure to develop a more national insurance market to increase consumer choice and portability has resulted in the FIO Modernization report's recommending action on several market place issues. The involvement of the federal government in this area will signal further change and possibly increased uniformity and cross-border availability for the US market.

➔ Producer licensing

For several years, the NAIC has been implementing a uniform broker licensing law, but inconsistencies remain. Congress is now considering adoption of the National Association of Registered Agents and Brokers Reform Act. If passed, this law would create a national licensing system as an option, which the FIO report describes as a consumer benefit.

➔ Market conduct

Consumer protection is a main focus for the FIO and the Modernization report recommends uniform adoption of a number of NAIC model laws related to product approval and sales including the Suitability in Annuity Transactions Model Regulation and expansion of the Interstate Insurance Product Regulation Commission to commercial products.

➔ Rate and pricing regulation

Rate regulation is an issue the NAIC has not been able to address because of the political nature of the issue. Insurers may benefit by a FIO review of the issue. FIO has indicated it will work with State regulators to establish pilot programs for rate regulation to foster competitive markets for personal lines products. However, FIO's involvement may also signal limits on certain factors used in pricing. The FIO report has also called for an assessment as to the appropriateness of using marital status in underwriting or rating and will study the way in which personal information is used for insurance pricing and coverage purposes.

11. A covered agreement is a memorandum of understanding between regulators of different countries to cover matters regarding large, internationally active insurance groups. Dodd-Frank has a covered agreement provision that broadly defines prudential supervision matters that could be subject to such an agreement
12. FIO Report: How to Modernize and Improve the System of Insurance Regulation in the United States, p31.

The rise of the international standard setters – implementation and assessment

Since the financial crisis, the International Association of Insurance Supervisors (IAIS), the Financial Stability Board (FSB) and the International Monetary Fund (IMF) have placed a new emphasis on encouraging and measuring the implementation of international standards. That thrust has taken several forms and several different assessment programs are in place:

- **the Financial Sector Assessment Programs (FSAPs) conducted by the IMF and World Bank;**
- **the FSB's thematic and peer reviews; and**
- **the IAIS' self -assessment and peer review program.**

The assessments not only reveal information about the countries and recommendations for action, but also provide an assessment of how well the IAIS and other standards are being implemented. Importantly, they provide useful insights into the changing focus of insurance supervisors and we outline below these changes and the likely implications for insurers.

The Financial Sector Assessment Program (FSAP)

The Financial Sector Assessment Program (FSAP), established in 1999, is a comprehensive and in-depth assessment of a country's financial sector. In jurisdictions with financial sectors deemed by the IMF to be systemically important, financial stability assessments under the FSAP are mandatory, and are expected to take place every five years; for all other jurisdictions, participation in the program is voluntary. The reviews involve teams of experts, usually former supervisors, who spend upwards of a year reviewing the legal structure and resources in the country under review.

In light of these lessons learned from the financial crisis, in September 2009, the IMF and World Bank revamped the program, to include the following new features:

- **More candid and transparent assessments.** The introduction of a Risk Assessment Matrix is designed to make the analysis of stability assessments in the context of the FSAP more systematic, candid, and transparent;
- **Improved analytical toolkit.** New assessment methodologies were developed to better identify linkages between the broader economy and the financial sector; and cover a greater variety of sources of risk. Also, more emphasis was placed on cross-country links, spillover effects, and coordination arrangements;
- **More flexible modular assessments, tailored to country needs.** Instead of 'one-size-fits-all' assessments, there is now the flexibility to conduct financial stability or development assessments in separate modules, conducted by the IMF or the World Bank, respectively; and
- **Better targeting of standards assessments.** Risk-based assessments of the standards that apply to the regulation and supervision of banks, securities markets, and insurance were introduced to better target the assessments of these standards.

KPMG OVERVIEW OF FSAP RESULTS

		Singapore	Australia	Italy	France	Japan	Belgium	Malaysia	Spain	Brazil	Nigeria
Supervisory Powers and Measures	ICP 1 Objectives, Powers and Responsibilities of the Supervisor	3	2	3	3	3	2	2	3	2	3
	ICP 2 Supervisor	2	1	1	2	1	1	2	1	1	2
	ICP 4 Licensing	3	3	3	2	3	3	2	3	2	2
	ICP 6 Changes in Control and Portfolio Transfers	3	2	3	2	3	3	2	3	3	1
	ICP 9 Supervisory Review and Reporting	3	2	1	2	2	2	3	2	2	1
	ICP 10 Preventive and Corrective Measures	3	3	3	3	2	3	3	3	3	2
	ICP 11 Enforcement	3	3	2	3	3	3	2	3	3	2
	ICP 12 Winding-up and Exit from the Market	3	2	3	3	3	3	3	3	2	3
Solvency	ICP 13 Reinsurance and Other Forms of Risk Transfer	3	3	3	3	2	2	2	2	2	1
	ICP 14 Valuation	3	3	1	2	1	2	3	1	2	1
	ICP 15 Investment	3	3	3	3	3	2	2	3	3	2
	ICP 16 Enterprise Risk Management for Solvency Purposes	2	2	3	1	2	2	1	1	0	1
	ICP 17 Capital Adequacy	2	2	1	2	2	1	2	1	2	1
Group Supervision, Cooperation and Crisis Management	ICP 3 Information Exchange and Confidentiality Requirements	3	3	3	2	3	3	2	3	2	2
	ICP 23 Group-wide Supervision	3	2	3	3	3	2	1	3	0	0
	ICP 24 Macroprudential Surveillance and Insurance Supervision	3	3	2	2	1	3	3	1	1	1
	ICP 25 Supervisory Cooperation and Coordination	3	3	3	3	2	3	3	3	1	1
	ICP 26 Cross-border Cooperation and Coordination on Crisis Management	2	2	2	3	1	2	1	1	0	0
Conduct of Business, Intermediaries, and Fraud Prevention	ICP 18 Intermediaries	3	3	1	3	2	2	1	1	1	1
	ICP 19 Conduct of Business	3	1	3	3	3	2	2	2	2	1
	ICP 21 Countering Fraud in Insurance	3	3	2	3	3	3	2	0	3	1
	ICP 22 Anti-Money Laundering and Combating the Financing of Terrorism	3	3	2	3	3	3	3	3	2	2
Corporate Governance and Public Disclosure	ICP 5 Suitability of Persons	3	2	2	1	2	2	2	2	2	1
	ICP 7 Corporate Governance	3	3	3	1	2	2	2	1	1	2
	ICP 8 Risk Management and Internal Controls	3	3	3	2	3	3	2	1	3	2
	ICP 20 Public Disclosure	2	1	2	1	2	1	2	2	3	1
	Total	73	63	61	61	60	60	55	52	48	37

3 **Observed** 2 **Largely Observed** 1 **Partially Observed** 0 **Not Observed**

Source: KPMG International, March 2014

The IMF has recognized 12 areas and associated standards as the basis of its assessments (see chart). In the area of insurance regulation, the Insurance Core Principles (ICPs) developed by the IAIS have been used as the basis of assessment. The IAIS has recently said it would like to look more closely at how the reviews are performed and plans in the future to review the Assessment Methodology.

In October 2011, the IAIS revised its core principles. Since that time, ten Financial Sector Assessments (FSAPs) have been conducted based on the new ICPs. The jurisdictions assessed include: Australia, Belgium, Brazil, France, Italy, Japan, Malaysia, Nigeria, Singapore and Spain. The reports are summarized in publicly posted reports presented to the FSB and often result in changes to the existing laws in the countries assessed (some of the comments expressed in the country reviews are reflected in the country specific snap-shots in this report).

A review of the ten jurisdictions examined (see chart) indicate that Singapore had the highest level of observance, reflecting extensive reforms adopted in the last few years by the Monetary Authority. The Singapore review is the most recent, giving them additional time to review the ICPs adopted in 2011. The reviews of Australia, Brazil, Japan, and Spain, by contrast, took place in 2012. The European countries' levels of observance reflect the delay in the implementation of Solvency II, especially in regard to solvency and disclosures. Two of the emerging economies, Brazil and Nigeria, had the lowest level of adoption of the ICPs, while the recent reform efforts in Malaysia are reflective of its relatively higher observance level.

In examining the overall results of the level of observance of the various insurance core principles, we have grouped the ICPs into five categories: Supervisory Powers and Measures; Solvency; Group Supervision, Cooperation and Crisis Management; Conduct of Business, Intermediaries and Fraud Prevention, and Corporate Governance and Disclosure. The highest levels of observation were seen in the area of supervisory powers. This is not surprising since these ICPs reflect the basic regulatory powers and have been in place longer.[13] The noticeable exception is ICP 2 for which the level of observance was markedly lower, due in part to the IMF's view that the supervisor must be independent of political influence.

The observance in the conduct of business and anti-fraud area was also high, largely because of the strong push by the Financial Action Task Force (FATF) to enact anti-money laundering laws. The Solvency ICP levels of observation were surprisingly low due in part to the fact that the four European countries in the assessments have not yet adopted Solvency II's risk focused, economic valuation, however, Singapore, Australia and Japan were seen to be lacking in complete observance of the ICPs on risk management and capital adequacy. In the reviews, the IMF called for stronger guidelines to be set for company ERM programs and more risk sensitive capital requirements.

In general, the reviews demonstrate major themes that permeate the ten reviews:

- Independence of the supervisory authority is critical to the IMF, and in almost all cases, without evidence of any political interference, the issue of independence was raised;
- The ability of the supervisor to act quickly to take action against a company was considered a weak spot in many regimes, where multiple layers of authority are required;
- Corporate governance requirements need to be specific to insurance company functions, including oversight of the actuarial functions. Relying on general corporation law was deemed insufficient;
- The supervisor must have multiple intervention tools at their disposal, so that there is flexibility along a ladder of intervention;
- Valuations must be responsive to risk and capital requirements and must be risk sensitive. Solvency I type requirements have always been considered as insufficient. The use of amortized cost was also questioned;
- Supervisors need to develop skills and resources to be able to evaluate enterprise risk systems and controls and to set specific expectations for company ERM programs;
- Consumer protection in terms of active intervention as to conduct in claims handling and mis-selling was stressed. On site market conduct reviews were encouraged;
- Group supervision needs to be improved in many cases, but for several jurisdictions this was recognized as a low priority; and
- Macro-prudential surveillance needs to be improved.

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13. ICP 9 on Supervisory Review and Reporting was revised in October 2012 to add new reporting requirements and on-sight inspections, but these IMF assessments were based on the previous version of ICP 9.

FSB peer reviews

Recently, the G20 instructed the FSB to supplement the five-year assessments conducted by the IMF, with peer reviews. These country reviews provide an interim measure regarding the status of changes taking place to correct deficiencies noted in the full reports. In 2013, the country reviews were completed on the United Kingdom, the United States, and South Africa. The reviews were designed to provide a status report on progress towards implementing the recommendations in the previous FSAP. Many of the reports focused on the success of revisions to the regulatory and supervisory structure in those countries and the implementation of solvency changes. Since all the reviews were based on the old ICPs, the new reviews did not consider the additional ICPs.

FSB thematic reviews

The FSB is also undertaking thematic peer reviews focusing on certain areas of regulation. This year thematic reports were completed on resolution regimes, risk governance, and first the phase of a peer review on the use of credit rating agencies in regulation.

The objective of the thematic review on resolution regimes compared national resolution regimes both across individual FSB key attributes for effective resolution regimes and across different financial sectors (banking, insurance, securities, and financial market infrastructure). The report found that implementation of resolution regimes was at an early stage. The FSB reiterated its call for full implementation of the key attributes, committed to the preparation of additional guidance, and recommended continuous monitoring of adoption of the key attributes.

The thematic review of risk governance found since the crisis national authorities have taken several measures to improve regulatory and supervisory oversight of risk governance at financial institutions. These measures include:

- developing or strengthening existing regulation or guidance;
- raising supervisory expectations for the risk management function;
- engaging more frequently with the board and management; and
- assessing the accuracy and usefulness of the information provided to the board to enable effective discharge of their responsibilities.

Nonetheless, the FSB concluded that national authorities would need to strengthen their ability to assess the effectiveness of a firm's risk governance, and more specifically its risk culture, to help ensure sound risk governance through changing environments. Supervisors will need to undergo a substantial change in approach since assessing risk governance frameworks entails forming an integrated view across all aspects of the framework.

The full report on the use of credit rating agencies (CRA) in regulation will be released in 2014, but the initial peer review indicates that significant progress has been made in deleting 'hard-wired' references to credit rating agencies in domestic laws and regulation. The report found that use of CRA ratings appeared to be less of an issue in the prudential supervision of non-bank financial institutions with insurance supervisors, for example, reporting relatively few references to CRA ratings in their rules and regulations.

IAIS peer reviews on ICPs

To round out the assessment program, the FSB asked the IAIS following the adoption of the ICPs to undertake a self-assessment and peer review program regarding the adoption of the ICPs. The IAIS developed a five-year plan to do so based on the following schedule:

- 2012: Mandate and Supervisory powers (ICPs 1 and 2)
- 2013: Group-wide Supervision (ICP 23 and related provisions)
- 2014: Corporate and Risk governance, (ICPs 4, 5, 7 and 8) and Access to Insurance (based on the Application Paper on Inclusive Insurance Markets)
- 2015: Supervisory Measures (ICP 6, 9, 10, 11 and 12) and Market Conduct (ICPs 18 and 19)
- 2016: Solvency (ICPs 14, 15, 16, and 17)

Supervisors are now investing significant resources to increase the current supervisory capabilities – particularly in regards to group-wide supervision. This will apply more scrutiny on groups and their group-wide ERM, capital and governance frameworks.

In each case, the IAIS develops a questionnaire to be sent to its 200 member jurisdictions. The supervisor in each jurisdiction is asked to complete the assessment. The IAIS expert review team assesses the implementation efforts in each country against the overall benchmark and sends a detailed report to the participants regarding areas needing improvement. The reports indicate areas that are observed, largely observed, partially observed and not observed. The IAIS also completed a detailed report for the FSB on each country and a summary report of the overall status. A shorter composite report without specific country information is released publically. Thus far two assessments have been completed: ICPs 1 and 2 on the powers of the supervisor and ICP 23 on group-wide supervision and the initial report has been drafted on corporate governance.

The participation and results of the first self-assessment (by the supervisors themselves) on supervisory powers and authority was very positive with over 82 authorities participating. Observance of ICPs 1 and 2 was very high, although there were no fully observed participating authorities for ICP2 on supervisory functions and powers. Several areas were identified as needing further guidance including proportionality, political independence, public consultation, adequate funding and resources, conflicts of interest, outsourcing and appeals.

In contrast, the second review on group supervision revealed problems with the application of the ICPs related to groups, which had led the IAIS to undertake a revision of ICP 23 on group supervision and related provisions in at least 10 other ICPs. This self-assessment was only completed by 59 jurisdictions. The majority of jurisdictions were partly observed or not observed. The Review Team felt the number of standards involved and the fact that the assessment took place at the same time that many jurisdictions were still developing legislation instituting group-wide supervisory frameworks complicated observance. Several years since the global financial crisis, it is perhaps surprising that regulators have not moved more quickly to address the lack of group-wide supervisory powers within their respective jurisdictions.

The preliminary report on corporate governance indicates a high level of observance of the ICPs, particularly ICP 4 (Licensing) and ICP 5 (Suitability of Persons). On balance, ICP 7 (Corporate Governance) was only largely observed. The IAIS report suggests this may be due to the fact that in many jurisdictions, corporate governance requirements are not included in the insurance law. The IAIS is encouraging countries to supplement their corporation codes with specific insurance requirements. ICP 8 (Risk Management and Internal Controls) was the area with the lowest level of implementation, due in part to the substantial changes made to this ICP in 2011. Many jurisdictions indicated they were still in the process of adopting the requirements. The IAIS has recommended a more proactive approach by supervisors to ensuring that internal controls are in place within insurers.

To help improve the implementation, the IAIS has adopted a Coordinated Implementation Framework (CIF), which includes:

- Regional engagement;
- Enhanced relationships with implementation partners;
- A renewed focus on implementation activities; and
- Alignment of IAIS implementation activities and standard setting.

In announcing the new program, the IAIS is very aware of the need to assist its members increase their supervisory capacity and provide them with a plan to achieve full observance of the ICPs. Such an acknowledgement reflects the current state of insurance supervision and will ultimately be critical for ComFrame to be implemented successfully.

IMPLICATIONS FOR INSURERS

The current pace and change of insurance supervision will likely impact insurers in a number of ways:

- Greater external oversight and assessment programs by bodies such as the FSB and IMF World Bank will only continue to force the reform agenda amongst supervisory authorities;
- Supervisors are now investing significant resources to increase the current supervisory capabilities – particularly in regards to group-wide supervision. This will apply more scrutiny on groups and their group-wide ERM, capital and governance frameworks;
- The timetable for the IAIS peer review is clear and a step-change will be required by many supervisory authorities resulting in a likely acceleration of reform which will likely require many insurers to increase spending and resources on their overall risk and capital frameworks and require greater Board involvement;
- The focus on insurer's risk management practices will continue particularly in regards to the adequacy of governance and risk culture arrangements employed by insurers. A change in risk behaviors will be expected; and
- Subsidiaries and branches of insurance groups will be under greater pressure to outline how their particular operations are coordinated and managed within the group, particularly with regards to risk and capital issues given supervisors will be applying more supervisory intensity on understanding the group's total balance sheet.

Asian regulators are now moving to reform their local requirements to better reflect global developments, particularly in regards to risk-based capital frameworks, greater reliance on insurer's own assessment of risks and wanting increased governance accountability from Boards and senior management.

ASPAC perspective

Many insurance regulators in the ASPAC region continue to actively re-work their overall supervisory structures and re-evaluate their regulatory frameworks in a wide number of areas. For example, developments relate to:

- Generally enhanced levels of supervision;
- More risk-based supervision and changes in how supervisors conduct both off-site and on-site supervision;
- Greater focus on the Board and Senior Management relating to compliance and risk assessments;
- Increased focus on group-wide supervision and systemic issues;
- More detailed reviews of off-balance sheet and non-insurance business exposures;
- Greater scrutiny of an insurer's outsourcing policies for key roles and functions; and
- Additional data requests of insurers, with one objective of enhancing macro-prudential surveillance.

Driving these changes is a number of regional and global initiatives that are heavily influencing the form and style of supervisory focus, such as:

- ASEAN developments;
- Continued influence from banking and securities sectors' reform;
- Influence from other insurance markets such as the European Solvency 2 developments;
- Accounting changes especially with regard to IFRS 4 Phase II developments; and
- The latest IAIS international developments such as the IAIS Insurance Core Principles (ICPs), ComFrame and systemic risk developments.

The relatively new IAIS ICPs and standards continue to have a heavy influence in the reforms currently underway across the ASPAC region. The introduction of such standards is evidenced by many jurisdictions:

- Moving towards an economic valuation basis for insurance liabilities;
- Raising the highest solvency control level to that more aligned with other international requirements such as being linked to probability levels of failure similar to Europe's Solvency regime;
- Further improving their Enterprise Risk Management (ERM) standards and group risk management requirements;
- Introducing stress and scenario tests;
- Giving greater regulatory and supervisory attention to the adequacy of insurer's reinsurance arrangements, particularly with regard to natural catastrophe exposures;
- Maximising the value of macro-prudential analyses and cooperating more proactively with foreign supervisors; and
- Requiring more public disclosure of risk and concentration information.

Impact for insurers:

Given many international insurers are already subject to many of the standards outlined above in their home markets, it should come as no surprise that regulators across the ASPAC region are taking greater action. The impact for insurers in the region of these developments are significant, particularly in regards to their solvency and capital management systems; the increasing need to focus on systemic risk and general risk management ; greater pressure to improve the way insurer's communicate with investors and regulators and developments concerning insurance contract accounting.

The development of the FSB and IAIS efforts to enhance macro-prudential surveillance, in particular systemic risk analysis, could result in such requirements being applied more broadly across the region at the local level with supervisors requiring more information concerning an insurer's strategic plans, product offerings, asset strategies and capital requirements. Local Asian regulators are taking considerable interest in the recovery and resolution planning (RRP) requirements arising from the IAIS and are particularly concerned with the potential impact another crisis could have on local entity capital and liquidity management and the subsequent regulatory impact this could cause – especially in regards to the disposal of assets or need to ring-fence local solvency. The need for insurer's to have greater data predictive capability is now evident.

Groups

Similarly, it is expected that the competitive dynamics within the sector may change in some markets given the introduction and enhancement of RBC regimes across the ASPAC region. Insurers will need to assess these competitive shifts and ascertain the impact this may have on their strategic and business planning processes. This is particularly an issue concerning the fungibility of capital between entities within a group and may change the appetite and drivers of M&A activity. Greater consolidation may arise as a result.

For groups, other considerations also need to be considered. For example, many Asian insurers are still characterized by legacy group structures which may not be optimized for today's regulatory and tax landscapes. It is expected that capital, tax and operational efficiencies will continue to drive insurers to reconsider existing group structures, particularly, a focus on 'leaner' operations which are forcing many Asia Pacific insurers to seek new and innovative sourcing solutions to improve operational efficiency.

Consumer protection

In regards to consumer protection issues, supervisors across the ASPAC region continue to seek the fair treatment of customers in general. Supervisory reviews are increasingly focusing on the sales practices and management of the risk of mis-selling. Insurers and their agents will therefore need to ensure that evidence is maintained that clearly illustrates compliance; from needs-based sales assessments to internal policy compliance. Similarly, the management of conflicts of interest and remuneration of intermediaries continues to be an area of increasing interest for regulators including the overall internal controls environment and procedures relating to customer interaction and the management of customer complaints. In particular, supervisory attention will continue to heavily focus upon:

- Whether insurers are employing ethical sales practices;
- The degree of transparency and level of information provided before, during and after sales;
- Reducing the risk of sales which are not appropriate to customers' needs;
- Ensuring that any advice given is of a high quality;
- Insurer's dealing with customer complaints and disputes in a fair manner; and
- Managing the reasonable expectations of customers, including adequate protection concerning the privacy of information obtained from customers.

This increasing volume of regulation across the ASPAC region will likely impose additional demands on compliance functions especially in regards to the education and level of knowledge of sales and customer management teams. An increased set of underwriting guidelines requiring adherence and a growing number of checklists and audits will likely witness a need for greater compliance effort.

AUSTRALIA

The Australian insurance regulatory environment continues to evolve. The Australian Government has recently announced a new Financial System Inquiry will take place and charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth, with a particular focus on fostering an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users. The report is due to be presented to the Treasurer this November. Notwithstanding, the insurance regulators remain focused on capital, governance and risk management practices.

Regulatory capital

In January 2013, the Australian prudential regulator, the Australian Prudential Regulation Authority (APRA), introduced a new risk-based regulatory capital framework for the insurance industry (often referred to as Life and General Insurance Capital (LAGIC)). The LAGIC reforms introduce a three-pillar supervisory framework covering:

- Pillar 1 – quantitative requirements;
- Pillar 2 – qualitative requirements and regulatory supervisions; and
- Pillar 3 – reporting requirements.

Under Pillar 1 requirements, risk capital charges are determined in respect of asset risk, asset concentration risk, insurance risk, insurance concentration risk (in the case of general insurers) and operational risk. Risk capital charges are determined based on prescribed stresses to the regulatory balance sheet, with allowance made for diversification between risks and products, and any management discretion available. Pillar 2 involves an insurer's own assessment of its capital needs (known as the Internal Capital Adequacy Assessment Process (ICAAP) and allows the regulator to impose additional capital requirements if it deems that the insurer's own capital management plan is inadequate.

On 1 January 2014, the last element of the general insurance reform, being a natural perils horizontal requirement, came into effect. Insurers are now required to stress test the impact of multiple losses from natural perils occurring in one year. This element completes the insurance concentration risk charge. APRA has also recently shown focus on the adequacy of catastrophe models applied by general insurers. The key changes for life insurance are the requirement to determine risk margins for the first time (previously risk margins are to be held within a prescribed range), allowing the use of diversification benefits which offset somewhat the prescription of significantly more stresses and higher stresses.

The LAGIC reforms go beyond a technical determination of regulatory capital. The ICAAP was introduced to integrate a company's risk and capital management processes in a way that can support business decisions. Insurers are focusing their efforts on enhancing and integrating their ICAAPs into the business.

Risk management and governance

In January 2014, APRA released a package of final cross industry risk management requirements (known as CPS 220) which become effective from 1 January 2015. These apply to Authorized Deposit-Taking Institutions, general and life insurers, authorized non-operating holding companies, and single industry groups. Its objective is to ensure consistent application of its risk management requirements across these regulated industries. APRA's approach to risk management is based on a three lines-of-defence risk governance model. The main requirements:

- APRA will require a designated person, referred to in CPS 220 as the Chief Risk Officer (CRO), responsible for the risk management function. Institutions must designate (rather than dedicate) a person responsible for the risk management function. Institutions are not required to classify such a person as a Chief Risk Officer.
- CPS 220 continues to preclude the Appointed Actuary from being the CRO as well as the Chief Executive Officer, Chief Financial Officer and Head of Internal Audit.
- APRA has maintained the requirement for the CRO to have a direct reporting line to the CEO. In this respect where an APRA-regulated institution is part of a group, the CRO of that institution may report to the group CRO provided the group CRO reports to the group CEO.
- APRA has clarified that the CRO may have also responsibility for the compliance function.
- CPS 220 states that APRA may consider alternative arrangements for institutions that can demonstrate they meet, in substance, the principles underlying the CRO requirements and the objectives of CPS 220. This is explained as being expected to apply to smaller and less complex institutions (including Australian branch operations).
- APRA also states that regulated institutions may engage the services of an external service provider to perform part of the risk management function where the institution can demonstrate that the risk management function meets certain requirements.
- Under changes to the related prudential standard on Governance, CPS 510, APRA has introduced the requirement for separate Risk and Audit Committees of the Board.

Health insurance

In September 2013, the Private Health Insurance Administration Council (PHIAC) introduced new Capital Adequacy and Solvency Standards which are due to come into effect in stages from 31 March 2014 to 1 July 2014. According to PHIAC, the changes have been made to allow the standards to:

(a) better address the key risks faced by health insurers;
(b) improve insurers' engagement with those risks; and
(c) improve the quality of information available to support PHIAC's regulation of the industry.

PHIAC expects that the changes to the standards will lower capital requirements. The Regulation Impact Statement that accompanied the changes notes that across the health insurance industry, capital requirements could reduce by around 60 percent (or A$1 billion).

Primary distribution

Distribution in Australia is dominated by direct sales, broker and agency channels. The market clearly distinguishes between general, life and health insurers. Only a few insurers act across all segments. An Australian Financial Services License is generally required to distribute insurance products. In recent years aggregators have entered the market, challenging the established distribution channels, in particular for health insurance.

M&A and foreign direct investment

There is no limitation on foreign ownership in Australia. The general and life insurance segments are dominated by a few large players. Increased M&A activities are currently noted in the insurance broking industry. In addition, there has been a further consolidation within the six largest general insurers, although the acquisition is still subject to regulatory approval.

FSAP

In 2012 the IMF conducted an FSAP of Australian's observation of the newly adopted ICPs. The assessors found the risk-based supervision framework to be comprehensive and well-documented and that APRA has adequate supervisory resources and technical capacity to conduct effective supervision. The report found a high level observation generally, but did encourage APRA to be more proactive in its consumer protection activities and oversight of intermediaries.

Equivalence

Australia has applied for temporary equivalence under Solvency II.

CHINA

The insurance regulatory framework in China is developing rapidly. The 2012 Financial Sector Assessment Program (FSAP) highlighted significant areas of development. The China Insurance Regulatory Commission's (CIRC) focus is gradually shifting from 'front end' pricing/product/investment regulation to more 'back end' supervision such as solvency and reserving. There is a sign, as seen through recent regulatory developments, that the CIRC is favouring a consultation model of change in certain circumstances. Following the Third Plenum of China central leadership, which has promulgated a comprehensive government and market reform agenda, CIRC has accelerated insurance regulatory reform in a number of fronts.

Solvency capital
CIRC is developing the China Risk Oriented Solvency System (C-ROSS), a three-pillar risk and solvency framework with Chinese characteristics such as more emphasis on Pillar 2 (qualitative measures) and special considerations for emerging insurance market. The impact on capital is unclear at this stage. However, the new solvency capital regime will be more reflective of individual company's risk profile and will encourage enhanced enterprise risk management by company management. It is also worth noting that CIRC has followed a rigorous consultation process, which includes fifteen research projects involving insurers, consultancies and academics. A full consultation paper is expected to be released in 2014 and the framework to take effect in 2015–16.

Health insurance
In August 2012, the CIRC announced that the current medical scheme will be expanded to include the treatment of serious illnesses, to prevent patients from being reduced to poverty by medical costs. Qualified commercial insurers will be selected to operate this program. By the end of 2013, piloting programs in corporation with local government have been initiated in fifty-nine cities across the country and many more programs are expected to be launched in 2014-15. CIRC is also exploring ways in which private health insurance can participate in the rural medical scheme.

Primary distribution
Distribution in China is still dominated by the agency channel. CIRC is imposing stricter qualification requirements for professional sales forces and encouraging insurers or car manufacturers to set up professional insurance agencies. The direct channels of telesales and internet sales are growing strongly. CIRC issued a guidance to regulate P&C tele-marketing in January 2013. There are strong penalties for 'inappropriate behavior'. CIRC is also consulting on a new regulation on internet distribution of approved life products, which is expected boost growth of small insurers with limited branch network. For bancassurance, a new regulation jointly issued by CIRC and CBRC has encouraged sales of protection products and introduced consumer protection measures such as longer grace period, more disclosure requirements on investment linked products sold to elderly and low income customers.

Investment
Following the opening up overseas investment for domestic insurers in 2012, CIRC is revamping other investment regulations such as replacing detailed quota rules on individual investment types with broad concentration and proportion limits for insurance investment. The changes are expected to increase investment yield for the industry while promoting better risk management practices.

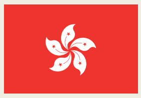
Product pricing
In August 2013, CIRC issued a new life insurance regulation removing the pricing interest rate cap of 2.5% promulgated fourteen years ago. The change only applies to traditional protection products initially, but is expected to gradually expand to participating, universal life, unit link, and annuity products. For motor insurance, CIRC continues the consultation process to gradually implement the de-tarrification of both compulsory motor liability and commercial motor premium rates.

Catastrophe insurance
With the support from CIRC, pilot catastrophe insurance programs incorporating local government financial support, catastrophe fund through donations, and commercial insurance purchases have been started in Shenzhen and Yunnan. Similar programs in other provinces and more central government policy support are expected to take effect in the coming few years.

M&A and foreign direct investment
The foreign ownership limits in China are 50 percent for a life insurer, 100 percent for a non-life insurer, 24.99 percent for investment in a domestic insurer and 19.99 percent individual investment limit for the insurer to retain its designation as a domestic insurer. It is expected that the opening of the compulsory motor insurance market to foreign insurers – and the partial de-tariffication of voluntary motor insurance – will contribute to an increase in M&A activity and further investment within the P&C sector.

Equivalence
China has applied for temporary equivalence under Solvency II.

HONG KONG



The Office of the Commissioner of Insurance (OCI) is proposing the establishment of the Independent Insurance Authority (IIA) to replace the existing insurance regulator. The IIA will be responsible for regulating insurance companies and insurance intermediaries, including their financial stability and sales conduct, and should receive greater financial support from which to supervise and regulate the market in due course.

Solvency capital
The current capital regime in Hong Kong is rules-based and the capital requirement is calculated simply based on premium and insurance reserves. The OCI is currently in development of a RBC framework – a consultation paper is expected to be released in the first half of 2014. The impact on required capital is unknown and may remain so until 2014 or 2015.

Health insurance
The Hong Kong government proposed healthcare reform in 2008 that is aimed at reducing the burden on the public healthcare system. The so-called Health Protection Scheme (HPS) is currently under development. The impact on the healthcare insurance market is not yet known though many insurers have publicly indicated their support for the scheme.

Primary distribution
Insurance agents and brokers are the primary distribution channel for the Hong Kong insurance market. Bancassurance is gaining significant momentum and prominence as a promising alternative distribution strategy. Banks in Hong Kong are limited to being an insurance agency for a maximum of four insurance providers. Most leading banks in Hong Kong already have bancassurance partners in place. Sales to mainland Chinese citizens are growing rapidly.

M&A and foreign direct investment
Currently, there is no limitation on the foreign ownership in Hong Kong, which contributes to the dominant role played by foreign insurers in the market. In response to the high levels of competition and future expected growth in the market, a number of M&A activities were observed in recent years. Developments in RBC, HPS and the continued increase in cooperation between Hong Kong and mainland Chinese insurance authorities may also drive M&A activity in the future.

Equivalence
Hong Kong has applied for temporary equivalence under Solvency II.

INDIA

As evidenced by the Unit Linked Insurance Plan's (ULIPs) changes, regulatory change can be swift and come without a long lead-in time (however, the recent revised regulation for linked and non-linked products has put strain on insurers as all products need to be re-filed with the Insurance Regulatory and Development Authority (IRDA)). There is a recent focus on facilitating needs-based selling, with objectives of transparency and protecting customers. The recent FSAP report highlighted several interesting market observations.

Solvency capital
India is currently utilising a factor-based solvency model, with a solvency margin requirement of 150 percent. The IRDA has decided to move towards a RBC approach and is taking reference to regulation in some overseas countries. In February 2013, the IRDA issued an exposure draft on a RBC framework which proposed to lower the solvency margin of insurers to 145 percent – the requirement will be applicable from the 2013/14 financial year.

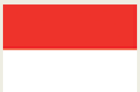
Health insurance
IRDA has issued Health insurance regulation in February 2013 that seeks to address several issues in this rapidly growing sector.

The changes propose to introduce, inter alia, standard wording in health insurance policies, pre-authorization forms and claim forms – this should improve efficiency, increase transparency to policyholders, and support future growth in this sector.

Primary distribution
Agency channel dominates the distribution network. KPMG member firms are seeing growth in internet sales from leading private insurers. The government is keen to expand distribution of insurance products to the rural population – bancassurance may support this objective. In July 2013, the IRDA issued a regulation that allows banks to become insurance brokers for multiple insurers; that said, banks who own insurance companies may assess the risks before doing so. Notwithstanding these changes, regulation regarding the future of bancassurance is not yet clear and is still under discussion.

M&A and foreign direct investment
Foreign ownership is restricted to 26 percent, with a restriction on one joint venture arrangement. The Insurance Laws (Amendment) Bill, 2008, which permits FDI to increase to 49 percent, has been approved by the Union Cabinet in October 2012 but has not moved forward due to political difficulties. With continued capital strain of new business and general expected growth in the sector, M&A opportunities are expected to remain, although arguably are less attractive than other markets. In 2013, IRDA has issued regulation on life insurance M&A regulatory approval, which provides clarity on the process.

INDONESIA



Starting from 2013, the Financial Services Authority (OJK) took over several regulatory and supervisory roles and functions presently held by Bank Indonesia (BI) and BAPEPAM-LK. Currently, the OJK is still adjusting and forming its selected approach for the supervision of insurers.

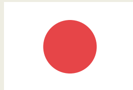
Solvency capital
Indonesia is currently developing an enhanced RBC framework. The latest enhancement that governs the risk-based solvency margin calculation became effective on 1 January 2013. The calibrated increases in the minimum capital requirement are continuing and will culminate by the end of 2014. The minimum capital for insurers and reinsurers will increase to IRD 100 billion and IDR 200 billion respectively.

Health insurance
The Indonesian government is understood to be implementing a new social security system, to be effective on 1 January 2014. All Indonesian citizens and foreign citizens who have lived in Indonesia for a minimum of six months shall participate in this social security system and pay monthly contribution/premium. It is still unclear to the market how this system may affect the private health insurance market.

Primary distribution
Distribution in Indonesia is dominated by the traditional agency channel. The regulators introduced licensing requirements for agents in 2010, where only licensed agents are allowed to sell insurance and agents can no longer represent two insurance companies at the same time. Bancassurance is a large and growing distribution channel. Several life insurance companies have adopted a direct telemarketing approach.

M&A and foreign direct investment
The maximum share for foreign investors to invest in an insurance company in Indonesia is 80 percent. However, existing foreign shareholders may increase their shareholdings beyond the 80 percent limit by injecting more capital into the company in order to meet the higher RBC requirements. There have been public discussions about how this might change in the future, as competition increases in the insurance industry, more local insurance companies are looking for foreign partners (capital and knowledge transfer).

JAPAN



The regulator, JFSA has announced their supervisory policy for 2013-2014. According to this policy, they have three focusing areas which are the development of claims payment systems in an appropriate amount on a timely basis, enhancement of improved risk management and advancement in customer protection and benefit.

Solvency capital
Japan has implemented an RBC-based solvency regime. According to the current solvency regulation, risks are categorized as insurance (both life and non-life), interest, market, credit, operation and catastrophe. Each risk amount is computed by multiplying risk exposure by a risk rate. The detailed calculation methodology and risk rate table is determined by the JFSA. The JFSA has updated these risk rate tables based on recent actual conditions in the market, claims and other data since 2012 in order to reflect the substance of risks. The RBC-based regime on a group basis was also introduced in 2012 in the same way as the stand-alone basis.

The JFSA has been continuously working in development of economic-based solvency regime in parallel of maintaining the current RBC-based framework.

Health insurance
Japan has the national health insurance program. However, Japan is noted for the longevity of its people and some commentators are concerned about the possible financial deficit of this program. Under such circumstances, health insurance products, particularly whole life health insurance products which are issued by private insurance companies, have become more popular in recent years. The JFSA has required a stress test for health insurance to be performed annually given the long-term health insurance assumptions concerning risk and other factors remain uncertain.

Primary distribution
The distribution channel in Japan has recently become mixed. Large life insurance companies have maintained sales representative channels historically and others have mainly used an agent and broker platform. In addition, bancassurance has become popular as a means of distribution while the traditional channel of distribution for non-life insurers has been the agency model. The use of direct channels, such as the internet has grown in popularity recently. Accordingly, the JFSA will revise an insurance sales rule from a customer protections' perspective.

M&A and foreign direct investment
In general, M&A's need an approval by the JFSA. Insurance companies can conduct FDI without the

JFSA's approval and there is no limitation in FDI amount or holding of shares. For both strategies, insurers are required to maintain their capital adequacy via the solvency regime. Given it is well publicized that the Japanese population will decrease in the future, Japanese Insurers appear to be seeking opportunities to invest in foreign insurers outside Japan.

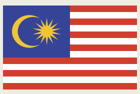
FSAP

Japan was the first jurisdiction to be assessed under the 2011 version of the ICPs. The report found that the FSA has been strengthening its insurance regulatory framework, including the solvency requirements applicable to insurers and insurance holding companies. The IMF recommended that the FSA build on this by completing the development of a methodology for risk-rating insurers, adopting a structured system for the internal review of risk assessments, and further increasing the level of resources to enable inspections to be performed more frequently. The IMF also recommended that corporate governance and suitability requirements be revised to strengthen independent oversight. The report noted that steps have been taken to enhance the supervision of Japanese insurance holding companies, cooperation with foreign supervisors, and market analysis capabilities and recommended that the FSA should continue to improve its ability to anticipate and deal with crisis situations by taking steps to maximize the value of its macroprudential analyses, developing contingency plans, and cooperating more proactively with foreign supervisors—including through the establishment of colleges of supervisors for Japanese insurance groups.

Equivalence

Japan has applied for full equivalence for its reinsurance regulation under Solvency II.

MALAYSIA



The regulatory priorities of Bank Negara Malaysia (BNM) continue to be guided by a domestic focus on raising standards further in governance and risk management practices. This is in keeping with the growing scale and complexity of activities of financial institutions in and outside Malaysia. Measures include strengthening and updating prudential rules in line with international regulatory standards.

Solvency capital

Malaysia implemented the current RBC framework on 1 January 2009. Traditional insurers have to maintain a capital adequacy ratio (CAR) above the Supervisory Target Capital Level (STCL) of 130 percent. Starting from 2014, Takaful operators also need to follow this capital requirement with the same STCL as traditional insurers.

Primary distribution

The agency channel is the dominant channel in Malaysia's insurance market, while bancassurance and direct sales are growing in popularity. The importance of bancassurance has increased in recent years since the removal of restrictions around entering into bancassurance arrangements. The recently enacted Financial Services Act (FSA) and Islamic Financial Services Act (IFSA) have prohibited several business practices; for example composite licenses are no longer allowed.

Health insurance

The Malaysian health insurance segment accounts for the lowest industry share of all other segments. The low market penetration rate provides opportunities for insurers and signals positive growth potential for the segment as a whole. There are no known significant regulatory developments impacting the health insurance segment at present.

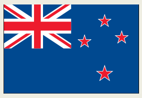
M&A and foreign direct investment

The life insurance industry remains dominated by foreign providers, while domestic firms control the general insurance industry. In 2009, foreign ownership limits were raised from 49 percent to 70 percent for branches of foreign insurance companies. Foreign equity above 70 percent is considered on a case-by-case basis. The new FSA and IFSA requirements may impact future M&A activity, e.g. requirements on minimum surplus of assets over liabilities for foreign branches and other prudential requirements.

FSAP

The IMF conducted a financial sector assessment of Malaysia in 2013. The assessors found the supervisor to be well respected and the level of observation of the ICPs to be good. Deficiencies were said to relate to matters of formalizing expectations into current guidelines, clarifying approaches in certain areas, enhancing transparency, and expanding the toolkit. Pending legislation was seen to be addressing risk management and group supervision issues.

NEW ZEALAND



Evolving Insurance Regulation

The New Zealand insurance industry is dominated by a few large players which are primarily Australian-owned. The industry has had much to grapple with in the last couple of years, from the introduction of a new regulatory supervision regime under the Reserve Bank of New Zealand (RBNZ), the continuing threat of natural catastrophes and the need for innovation and modified distribution channels.

The RBNZ's prudential regulation of insurers has been phased in since 2010, and is supplemented by the disclosure and competency requirements under the Financial Advisers regime. The RBNZ has reconfirmed its supervisory approach in respect of insurance, stating that its risk-based approach will focus on large insurers and/or those deemed to be at 'higher' risk of failure (with no guarantee of government support for insurer failure). Insurers can expect to see an increase in the financial and prudential information required by the RBNZ as the regime moves from its infancy into a more developed state, through regular information returns and thematic reviews. As seen in Australia and overseas, governance of and risk management within insurers will be key focus areas of the RBNZ.

Regulatory capital

Risk-based solvency standards are in place for Life Insurance, Non-Life Insurance and Captive Insurers which outline for each business line the Solvency requirements and calculation bases prescribed by the RBNZ. The RBNZ released two new consultations at the end of 2013 in respect of the solvency treatment of financial reinsurance and guarantees.

Proposed changes to the accounting standards for insurers from the International Accounting Standards Board may impact upon the financial results and solvency capital position of insurance companies and thus this needs to be clearly factored into forecasts and solvency planning.

Health insurance

New Zealand has both a private and publically funded healthcare system. District Health Boards manage and operate public hospitals whereby residents are able to access free healthcare. A secondary private market of health insurance schemes also operate to fund operations and treatments in a more timely manner. These health insurance organisations are subject to the same prudential and Finance Advisers requirements.

Primary distribution

Insurance distribution channels and the innovation of these are seen as a major area of focus in the industry in New Zealand. Insurance is delivered to the market via both direct selling and an extensive broker channel. Comparative analysis websites for insurance plans are now available and are commonly a 'first stop' for consumers when embarking on acquiring or changing their insurance policy.

M&A and foreign direct investment

With the domination of Australian-owned insurance companies in New Zealand, and foreign investment activity, mergers and acquisitions are subject to the approval of the RBNZ, the Commerce Commission and the Overseas Investment Office. There has been a lot of M&A activity in recent years in the New Zealand insurance industry, increasing key players' market share, and market commentators predict this will continue as insurance organisations tackle weak profitability, technology advancements, changing distribution channels and an ageing population.

SINGAPORE

The MAS is a fore-runner of regulatory change in the ASPAC region and adopts a consultative approach. Several consultation papers on a wide range of regulatory issues have been issued by the MAS in recent years. Many other insurance regulators in the ASPAC region have a close eye on changes being implemented in Singapore, which act as a potential precedent for change elsewhere in the region.

Solvency capital

In 2012, the Monetary Authority of Singapore (MAS) released its first consultation paper on RBC 2, which aims to enhance the comprehensiveness of the risk coverage and risk sensitivity of the current RBC framework, including ERM and ORSA components. These requirements took effect from 1 January 2014. The MAS expects to issue the second consultation on the RBC 2 framework and conduct the first quantitative impact study in Q1 2014.

Health insurance

In relation to the Central Provident Fund, the Singapore government provides two medical schemes, Medisave and MediShield, for its residents to pay medical and hospitalization expenses. There are no known regulatory changes in relation to the private health insurance market in Singapore.

Primary distribution

Agents and brokers continue to dominate the insurance distribution channels in Singapore, although bancassurance and direct marketing are being increasingly utilized as alternative methods of distribution. Insurance agents in Singapore are now required to carry a special identity card before they can conduct business with clients with effect from 1 January 2013. On 30 September 2013, the MAS published its response to the Financial Advisory Industry Review (FAIR) consultation. The FAIR panel recommendations included: higher educational requirements for the 14,000 financial advisers working at insurers, banks and other financial advisory firms in Singapore; more stringent conditions on licensed financial advisory firms; new minimum base capital requirements; and lowering costs for consumers through, for example, developing an online aggregator for consumers to compare life insurance and critical-illness insurance products.

M&A and foreign direct investment

Currently, there is no limitation on the foreign ownership in Singapore. Developments in RBC 2 may lead to M&A activity, for example in the case that additional capital needs to be raised. Capital charges relating to overseas reinsurance business may be revisited by the MAS, potentially leading to changes in booking practices and/or restructuring of business.

FSAP

The IMF conducted an FSAP of Singapore in 2013 and found the level of observation of the ICPs to be very high and that significant progress had been made since the 2004 FSAP. The areas requiring improvement included independence, capital, enterprise risk management (ERM), and crisis management in light of the emerging risks of the insurance sector. In addition, given the material cross border operations in some of the insurers, MAS was encouraged to improve their crisis management by requiring large insurers with cross border operations.

Equivalence

Singapore has applied for temporary equivalence under Solvency II.

SOUTH KOREA

The regulator has in the recent past focused on claims fraud and the suitability of products for consumers, and more recently has been further developing the RBC framework alongside risk reporting and cash flow/asset liability modeling.

Solvency capital

RBC was implemented in April 2011. Under the current regime, a standard model is used to measure capital for insurance, market, interest, credit, and operational risks. The regulators recently enhanced the RBC regime by reflecting negative interest rate spread and strengthening the risk charge on insurance risk – as a result of these changes, some insurers witnessed that their solvency ratios reduced by half.

Health insurance

Historically, insurers withheld cancer products from the market due to poor underwriting performance, and only included cancer coverage as a rider to the main policy. That said and more recently, insurers started to introduce new cancer products by reflecting the actual cancer loss experience in pricing and strengthening underwriting criteria.

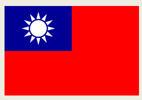
Primary distribution

The major distribution channel in Korea is agency and broker. A continuous increase in bancassurance has been noted in recent years. Internet sales is also gaining in popularity in Korea, however, the market share is insignificant compared to traditional distribution channels.

M&A and foreign direct investment

Any change in major equity holders' share that is over 10 percent of the insurance company has to obtain pre-approval from the Financial Supervisory Committee, though in practice this is not a complicated process. Due to the above changes implemented in the RBC framework, some insurers may seek to raise capital, or otherwise this may drive M&A activity.

TAIWAN



The Insurance Bureau, Financial Supervisory Commission is the local insurance regulator where significant focus is currently being directed at implementing and improving Enterprise Risk Management (ERM) and Internal Controls in the insurance industry. In addition, the regulator is keen to implement the Own Risk and Solvency Assessment (ORSA). It could be expected that insurers might be required to implement ORSA in the future so as to maintain the capital adequacy, reinforce the quality of management and protect the interests of policyholders.

Solvency capital

A Risk-Based Capital (RBC) framework has been implemented in Taiwan since 2001. The regulator reviews and amends the regulations for solvency capital annually to improve them. Currently, as a member of IAIS, it is mandated to adhere to the Insurance Core Principles (ICPs). Therefore, the regulator has been keen to follow up the international trend of solvency regulation including Internal Model, Solvency II and the Insurance Capital Standard (ICS).

Moreover, in order to deal with the future implementation of IFRS 4 Phase II, the regulator has launched many capital-related regulations gradually. For example, life insurers are required to submit a special annual report of the fair value of insurance reserves, with a set of sensitivity analyses on liquidity premium, based on the methodologies and assumptions developed by the Insurance Bureau, which are similar to IFRS 4 Phase II ED, designed to limit cash dividends distribution and to provide the asset increment as a special reserve if an insurer uses fair value in its opening IFRS statement of financial position as deemed cost for an investment property.

Health insurance
To reflect the trend of an aging society and low fertility, the government is keen to provide insurers with incentives to design insurance products which are specifically targeted for an aging society and long-term healthcare. For example, annuity, long-term healthcare insurance and medical insurance are key areas of focus to ensure the economic security of the elderly.

Primary distribution
In recent years, there is a rise of other distribution channels such as through Bancassurance channels, brokers, telemarketing and television. This has really impacted the traditional channel, agency force. In addition, the total first year premiums generated from Bancassurance has been the majority, over 50 percent as a whole; so that the Bancassurance channels have become the primary distribution in recent years. Therefore, the regulator has set out strict rules over Bancassurance channels to prevent them from potential disputes arising from inappropriate sales.

M&A and foreign direct investment
Given the developments in the EU concerning implementation of IFRS 4 Phase II, some foreign insurers' have begun selling off their operations in Taiwan to further alleviate the pressure of providing insurance reserves for the high guarantee interest rate policies. In addition, the regulator is raising the requirements of capital adequacy and imposing strict restrictions on cash dividend distributions. Some domestic insurers would like, through merger and acquisition, to increase their market shares, to develop distribution channels and to achieve economies of scale. This has also led to a rise of merger and acquisition activities within the domestic insurance companies.

THAILAND

Consistent with other countries in the region, the Thai insurance regulators have undertaken several initiatives to improve and enhance the existing regulatory framework. The focus of regulatory change appears very much to be on being 'right for Thailand' rather than merely copying other overseas regulatory regime changes.

Solvency capital
The Office of Insurance Commission is currently in the process of revising the regime with the aim of addressing shortfalls in the 2011 RBC framework, and introducing additional risk charges for operational, liquidity and group risks. Due to the significant impact on solvency caused by the 2011 flood, insurers were allowed to eliminate insurance and credit risk charges relating to flood claims and the associated reinsurance recoveries. The exemption is gradually being phased out.

Health insurance
Thailand is positioning itself as the health hub for neighboring countries and as such there is a lot of focus on health related products. Some banks have partnered with insurance companies to focus on selling health insurance to the bank's customers, especially those in the medium to upper income category.

Primary distribution
At the beginning of 2013, regulation on marketing and selling behavior of bancassurance was strengthened. For example, banks must differentiate the sale of insurance and securities products from core products, and they must disclose details of the insurance products to clients. This is a continuation of a general focus around sales practices in the industry. A recent discussion topic is the deregulation of pricing, mainly for motor insurance, but potentially more widely across the non-life and life sectors.

M&A and foreign direct investment
The maximum share for foreign investors to invest in an insurance company in Thailand is 25 percent. However, the regulator does allow a foreign share of up to 49 percent on a case-by-case basis, and over 49 percent for companies that are in financial difficulty. This foreign ownership limit also applies to other industries, which makes it difficult to change. Despite the capital exemption on the Thai flood in 2011, M&A activity was observed for (re) insurers that were in financial difficulty.

VIETNAM

The Vietnam Insurance Regulatory Framework continues to move toward to international practice.

Solvency capital
The current capital regime in Vietnam is rule-based with the requirements of minimum capital for each type of business (life insurance, non-life insurance, health insurance and reinsurance) and minimum level of solvency margin. The solvency margin is the difference between the assets and liabilities with certain discount on the accounting value of assets depending on their liquidity and the minimum level of solvency margin is calculated based on premium (non-life business) or insurance reserves and risk born insured sum. The regulation governing the solvency capital was issued in July 2012 so it is not expected to change in the near future.

Health insurance
In late 2011, the Government issued a decree allowing the establishment of specializing health insurance company with the minimum legal capital of VND300 billion.

Primary distribution
Agents are the primary distribution channel of Vietnam insurance market. Bancassurance and direct marketing are being increasingly utilized as alternative methods of distribution. In December 2013, the MOF issued the exposure draft Circular regulating bancassurance activities, in which the bancassurance activities will be regulated by the State Bank of Vietnam (banks) and the MOF (insurance companies). This Circular is expected to be officially issued in 2014.

M&A and foreign direct investment
Currently, there is a cap of 49 percent foreign ownership of listed insurance companies (general rule on foreign ownership of listed entities) and there is no limitation on the foreign ownership of unlisted insurance companies in Vietnam. However, the capital transfer of more than 10 percent capital of an insurance company needs to be approved by the MOF before execution.

The growth of consumer protection

Although solvency has been the primary focus of insurance supervisors for many years, particularly post the Global Financial Crisis, policymakers are now beginning to place a greater focus on market conduct issues and new structures are being established to develop standards and best practices in consumer protection. This chapter provides the latest updates from international supervisors on the changing conduct agenda and how these changes are likely to impact insurers.

In 2010, the G20 Leaders asked the Financial Stability Board (FSB) to work in collaboration with the Organization for Economic Co-operation and Development (OECD) and other international organizations to explore options to advance consumer finance protection. Complementing these national efforts are international initiatives, including the establishment of the OECD Task Force on Financial Consumer Protection, the expansion of the World Bank's Global Program on Consumer Protection and Financial Literacy to include implementation of financial consumer protection programs and development of good practices; and the refinement of the Network of Financial Consumer Regulators' (FinCoNet) mandate.

Notwithstanding these initiatives, the FSB has called upon international regulators to take a lead on global financial consumer protection efforts to further support international and national efforts; specifically to establish best practices and to ensure consumer protection authorities are equipped with the necessary supervisory tools to identify gaps and weaknesses in consumer protection frameworks. These changes are resulting in the development of specific policy recommendations at the IAIS and other regulatory bodies.

The IAIS is now developing and enhancing supervisory and supporting material related to market conduct supervision, providing oversight to the Financial Crime Working Group (of the IAIS) and coordinating with other international bodies dealing with the market conduct of insurers and intermediaries and financial consumer protection. In 2011, the IAIS adopted ICP 19 on Conduct of Business, its first specific standard in the area of market conduct. Although much of the focus is on conflicts of interest, disclosure, privacy protection, complaints handling, and dispute resolution, the ICP also addressed 'fair treatment of customers'.

The IMF Financial Sector Assessment Program (FSAP) also places great emphasis on the evaluation of ICP 19 and the need to develop strong conduct programs as a top priority. A noticeable outcome of these reviews has been the increased focus and need for broader supervisory authority in the

PACKAGED RETAIL INVESTMENT PRODUCTS (PRIPs)

The draft PRIPs regulation aims to increase the comparability, comprehensibility and presentation of information on retail investment products. The scope of PRIPs will cover:

- Investment Products: Any investment where the amount repayable is exposed to fluctuations in reference values or in the performance of the asset(s); and
- Packaged: 'Wrapping' of assets or other mechanisms (e.g. capital pooling, derivative instruments) – i.e. no direct holding.

The objectives are essentially twofold:

a) Retail investors should be able to understand the key features and risks of retail investment products and to compare the features of different products; and
b) Ensuring a level playing field through harmonization of the product disclosure rules for all investment products (i.e. banking, insurance and fund products).

The key requirement will be to introduce a product disclosure regime that will require investment product manufacturers to produce a standardized Key Information Document (KID). A KID needs to be provided to retail investors before the sale of the product.

Main elements:

- All manufacturers of these investment products (e.g. investment fund managers, insurers, banks) would need to produce a KID for each investment product that is being offered to retail investors.
- Each KID will have to follow the same standard regarding the structure and content and will need to provide retail consumers with information on the product's main features, risks and costs, and shall be considered as a stand-alone document.
- Distributors of investment products are also affected, as the draft Regulation sets out that whoever sells the product has the obligation to provide retail investors with the KIDs in good time before the investment decision.
- Disclosure requirements set out in the Prospectus Directive or the Solvency II Directive will exist in parallel. So products that fall under the scope of these Directives will have to comply both with them and PRIPs.

PRIPs will cover a range of investment products that are sold to retail investors. For example:

- All structured products, whatever their form (e.g. packaged as insurance policies, funds, securities or banking products);
- All types of investment funds, whether closed- or open-ended incl. UCITS;
- Products with capital guarantees, and those where, in addition to capital, a proportion of the return is also guaranteed;
- Insurance products whose surrender values are determined indirectly by returns on the insurance companies own investments or its profitability;
- Derivative instruments; and
- The above named products if used as individual retail pension products.

PRIPs however does not cover:

- Direct holdings in shares and bonds;
- Deposits (if the return is determined by interest rate);
- Plain insurance products (without investment component);
- Occupational pension schemes; and
- Pension products which are required by law or where the employee has no choice as to the provider.

The proposal also introduces rules for complaints, redress and cooperation as well as administrative sanctions and measures.

area of market conduct, on-site inspections of company practices, and dedicated staff focused on market conduct monitoring.

The IAIS is currently developing an Application Paper on Approaches to Conduct of Business Supervision, expected to be adopted in 2014. To obtain input into the latter it conducted a survey of IAIS Members (supervisory authorities) on their approaches to conduct of business supervision. The paper will also address monitoring, inspections, and corrective action in detail including product promotion, advertising, and product design. One of the key objectives of conduct of business supervision is to protect customers from potential abuse arising from the asymmetry of information and bargaining power between consumers and financial institutions. The IAIS believes that in jurisdictions or business models where customers have low financial literacy levels, the risk of such abuse is likely to be exacerbated.

The US has long-standing market conduct processes, including rate and form regulation, although these vary by State. The US is not exempt from the push for greater uniformity. The recent Federal Insurance Office (FIO) Modernization Report (see chapter 3) has an entire section on market place oversight, consumer protection and access to insurance. Recommendations call for more consistency nationally in market conduct examinations and standards for market conduct examiners.

The FIO also calls for greater uniformity in the processes for product approval and it calls on all the States to adopt the NAIC's Suitability in Annuities Transactions Model Regulation, which requires producers to have grounds for believing the recommendations to buy an annuity are suitable. As of yet, though, the IAIS has avoided imposing recommended regulatory action on product design. As consumer representatives become more active in the IAIS due to recent by-laws changes establishing a formal role for consumer entities, there may be pressure to address these issues.

EIOPA also regards consumer issues as one of its main priorities and hopes to bring greater harmonization of practices throughout Europe. EIOPA's understanding of its mandate in the area of consumer protection and financial innovation is broad, and some of EIOPA's tasks include analysis of trends; developing disclosure rules; and adopting guidelines to promote the safety and soundness of markets. In 2013, EIOPA published Guidelines for Complaint Handling by Insurance Intermediaries, following the 2012 release of similar Guidelines for Insurance Undertakings.

Product reviews and controls

Insurer selling and claims practices are at the core of market conduct considerations. Recent regulatory discussions focus on the appropriateness of product; bundling of products; product design; and promotional materials. The revisions to the European Insurance Mediation Directive (IMD2) as recently approved by Parliament introduces a ban on tying together different products, by requiring the components of a package to be offered for sale separately.

In 2014, EIOPA will shift its focus on consumer issues more towards the appropriateness of products. It plans to analyze life insurance product structures and innovative financial products. It will also work on common disclosures with the other regulatory authorities for Packaged Retail Investment Products (PRIPs). Recent amendments[14] will see the scope of PRIPS targeted at new rules for all investment products to retail investors, with the exception of insurance products and securities which do not offer a surrender value as well as officially recognized social security schemes. It is also likely not to apply

KPMG PERSPECTIVE

The addition of recovery and resolution requirements arising from systemic risk considerations is adding a new dimension to policyholder protection schemes and the adequacy of current regulatory structures. For example, within Europe, policyholder protection schemes are still administered at individual country level. Solvency II is a pan-European prudential framework, allowing insurers to easily passport across 28 national boundaries. However, most European insurance groups are still structured in the form of solo legal entities requiring for these subsidiaries solo capital and funding. For policyholder protection purposes, this invariably results in local supervisors wanting to maintain, understandably, the solvency of each entity. In times of crisis, the need to protect local policyholders becomes an overriding imperative for the immediate national authority concerned. For an insurance group's cross-border operations, such potential for unilateral action provides considerable uncertainty in the management of risk, capital and liquidity.

An integrated European-wide compensation scheme for policyholder protection purposes would go some way to alleviating these concerns. The benefits of such an approach are potentially significant given any resolution of a large European insurance group would rely heavily on cross-border cooperation and implementation amongst supervisors. Chief among these resolution considerations would be policyholder protection.

In this regard, there would appear to be a strong case for EIOPA involvement and facilitation for both group-wide prudential and conduct supervision of European insurance groups, assisted by local regulatory authorities where required.

Recent changes in intermediary regulation have also expanded to the mis-selling of products. In Europe, it is expected that the revisions to the Intermediaries Directive and the Markets in Financial Products will likely require insurance brokers to offer products separately, not just in bundles. Sales-forces' will be required to disclose potential conflicts of interest, such as their relationships with insurance companies, but each European Member State will be allowed decide for itself whether brokers must disclose the commissions they earn on sales.

In Europe, it is expected that the revisions to the Intermediaries Directive and the Markets in Financial Products will likely require insurance brokers to offer products separately, not just in bundles.

to officially recognized occupational pension schemes and individual pension products for which a financial contribution from the employer is required by national law and where the employee has no choice as to the provider. If these amendments proceed it will be the biggest expansion for EIOPA in the area of consumer production.

Anti-money laundering

One of the IAIS's core principles with the strongest adoption rates (see chapter 4) is ICP 22 on money laundering. In 2013, the IAIS adopted an application paper to provide information on how money laundering and terrorist financing can occur within the insurance sector and on controls to mitigate the risks. It provides specific information for insurers and intermediaries.

Policyholder protection schemes

The IAIS adopted an issues paper on policyholder protection schemes in 2013[15]. The paper acknowledges the role of protection schemes as part of the financial safety net and discusses various issues related to their organization, operation and functions. The issues paper identifies the need for supervisors to understand the protection afforded by such schemes that apply to insurers and policyholders under their jurisdiction.

In Europe, developing a European directive regarding guarantee schemes has made little progress and will be left to the next Commission to address. A white paper on the topic was issued in 2010, but there has been no follow-up on the proposals to create a more harmonized system of guaranty schemes in Europe.

Insurers need to review remuneration policies and controls for sales staff to reduce the risk of inappropriate sales which do not meet customer needs.

Privacy Protection and the Use of Data for Pricing

Insurers are also being called upon to improve both its handling and protection of data and the use of data in pricing and underwriting. In Europe, a new data privacy directive[16] is pending which will have an impact on insurers.

Marital status and gender remain key issues in the debate. A recent ruling in Europe[17] has limited the use of gender in ratings. The recent FIO report asks States to review the use of marital status in underwriting and rating and proposes that the States develop standards for the appropriate use of data for the pricing of personal lines insurance. The FIO will issue a report on the manner in which personal data is currently used for pricing and coverage purposes shortly.

14. European Parliament statement, 20 November 2013: *The European Parliament adopted amendments to the proposal for a regulation of the European Parliament and of the Council on key information documents for investment products.*
15. IAIS Issues Paper on Policyholder Protection Schemes, October 2013http://www.iaisweb.org/Supervisory-Material/Issues-papers-48
16. General Data Protection Regulation 2012/011(COD) amending Framework Directive 95/46/EC.
17. European Court of Justice Decision, March 1, 2011.

Insurers need to demonstrate that they gather the right data and perform meaningful analysis so that they treat customers fairly. Boards should receive useful MI on customer outcomes and decisions reached.

IMPLICATIONS FOR INSURERS

Examples of the increased regulatory focus on conduct of business

Reference	Area of focus	Business impact
Add-ons	Market conduct regulators are increasingly concerned over the appropriateness of add-on products, particularly when sold on an opt-out basis. Insurers need to consider if add-ons are suitable for clients and really address their needs.	Add-ons have contributed significant proportions of revenue in recent years. Insurers will need to review their products, sales practices, controls, and product disclosure.
Business model	Competitive pressures along with the drive for revenue can impact customers unfavorably. The balance between focus on profit margins and good customer outcomes is of interest to many supervisors.	Insurers need to demonstrate that the customer is at the heart of their business model. Customer expectations and service delivery should be considered alongside technological advances to increase efficiency and reduce operating costs.
Conflicts of interest	Many regulators now undertake reviews concerning conflicts of interests in the commercial market to ensure brokers act in clients' best interests in view of some remuneration arrangements between insurers and brokers.	Brokers should review remuneration arrangements to ensure there are no conflicts of interest or that they are suitably controlled. Insurers should consider the appropriateness of non-standard arrangements.
Complaints management	Supervisors are also increasingly undertaking reviews of insurer's complaints handling processes.	Insurers need to devote adequate and competent resources to complaints handling to ensure fair customer outcomes. There should be clear visibility of complaints at senior management levels and effective root cause analysis.
Conduct MI	Insurer's need to provide good data to senior management with sufficient detail and granularity. Also, insurer's may not be using the data which they have access to, in order to produce meaningful MI which drive effective decision making.	Insurers need to demonstrate that they gather the right data and perform meaningful analysis so that they treat customers fairly. Boards should receive useful MI on customer outcomes and decisions reached.
Product design and governance	Many supervisors are including product design as one of the key areas of review for onsite inspections. A concern is whether products are designed based on potential profit rather than genuine customer need.	Insurer's need to demonstrate value of their products through customer and market research, and transparency of pricing and charges.
Sales incentivisation	Sales processes and frameworks (including incentivisation) which encourage sales techniques which may lead to unsuitable customer outcomes.	Insurers need to review remuneration policies and controls for sales staff to reduce the risk of inappropriate sales which do not meet customer needs.
Renewal Pricing	Fair pricing treatment of long-standing customers who renew policies for many years without shopping around, particularly if they are less likely to have access to comparison websites and may be paying much higher premiums than a new business customer.	Insurers need to demonstrate that they are not exploiting potentially vulnerable groups of customers who do not shop around.
Culture/Trust	Regulators are increasingly focused on an insurer's culture in addition to their control functions. Many insurers are struggling with this change and the somewhat intangible nature of 'culture'.	Supervisors will want evidence that senior management genuinely see the importance of good customer outcomes and that for example, their leadership behavior and Board MI reflects this.

Source: KPMG International, March 2014

EMA perspective

Solvency II now within sight

Think of Solvency II and despite its positives, the words 'delay' and 'cost' are among the first that spring to mind. While the process has at times been painful for all parties, the outcome should mean Europe delivering on its objective of delivering better consumer protection to insurance policyholders through the enhanced risk and capital management that should result.

While we are still two years away from implementation, 2013 was a critical year in the Solvency II journey, with a solution to the long-term guarantees issue – the primary cause of delay over recent years – finally reached in the trilogue negotiations; and clarity on a 1 January 2016 implementation date.

For industry participants, there is now a renewed commitment to implementation that has been absent in recent years. One of the main reasons for this change is EIOPA's preparatory guidelines. These guidelines have focused the minds, reminding us that Solvency II is a pan-European initiative and that consistency of application across Europe is essential to enabling competition and a level playing field.

Insurers now have a much clearer picture of what they need to achieve in the two years to implementation. Equally, if not more importantly, is the dialogue between firms and their supervisors that will occur throughout this period, with the guidelines emphasising that the latter must feedback their findings.

This phase offers an opportunity for firms to sense check their interpretation of any aspects of the rules that are not clear, or where there is scope for different application, in a safe environment, without the threat of regulatory action in respect of non-compliance. Key within this is application of the proportionality principle – something that is meant to be enshrined into the fabric of Solvency II but sometimes seems elusive in the detail of the requirements.

This would unlikely not have happened if Solvency II had of been introduced years ago as originally planned, and it is not clear that the transitional measures alone would have provided this opportunity.

Most notably in this regard is the Own Risk and Solvency Assessment (ORSA) process, where the emphasis is strongly on the word 'Own'. Firms seeking internal model approval have had the opportunity to test their thinking with their regulator through the pre-application process. Few standard formula firms have had the same opportunity. The requirement to deliver a report on their Forward Looking Assessment of Own Risks (FLAOR) twice during the preparatory period will enable these firms in particular to gain from the supervisory review that follows.

Challenges ahead

But the guidelines also present challenges.

Firstly, there may not be consistent application across Europe. Each national competent authority (NCA), must determine the extent to which they will comply with the individual guidelines or explain why they are not doing so. Although required to 'make every effort to comply'[18], some NCAs may not have the legal framework to allow this, or may find some elements unduly burdensome to implement. Nevertheless, initial indications are that most NCAs are likely to adopt at least the majority of the guidelines.

However, where the guidelines are followed, the NCAs may interpret them differently – a problem that may be exacerbated by the translation process – and supervisory responses to any firm falling behind where the NCA expects it to be are likely to vary.

One of the greatest challenges will relate to the application to groups, and in particular group reporting. The use of thresholds that are based on significance to the local market at solo level and on the accounting gross assets at group level will lead to some anomalies, including:

- At a solo level, less significant entities within a group could be classified as 'threshold firms' and more significant entities not, due to the emphasis on local market;
- A group could be 'threshold' but none of its solo entities be so classified, for example due to the significance of non-EEA entities to the overall group.

Groups in these situations will need to determine how best to source the information needed from the non-threshold parts of the group. Whilst allowance is made for non-EEA entities to be included on a local basis within the group reporting, this is not extended to EEA non-threshold firms.

For both solo and groups, the challenges of parallel running of current and preparatory reporting needs to be carefully managed to ensure both can be reported within deadline, including both system and resource considerations.

It is also worth noting that since the worldwide group is excluded from the preparatory phase, these groups are still left uncertain as to how the group supervisor will determine the approach to be applied to them.

Benefits arising

Notwithstanding the challenges arising, the benefits of a safe field test cannot be underestimated. Solvency II is such a significant change for the industry, and perhaps more so in some continental European countries that do not currently have a risk-based regulatory framework, that the ability to engage with the regulator and agree approaches will be extremely useful.

Far from the preparatory phase holding up progress, this will give new momentum towards Solvency II compliance and allow time for areas of difficulty or challenge to be addressed. If used effectively by both regulators and insurers, it should prevent issues around day 1 compliance, and negate the need for subsequent regulatory action.

18. Article 16(3) EIOPA Regulations.

Solvency II is such a significant change for the industry, and perhaps more so in some continental European countries that do not currently have a risk-based regulatory framework, that the ability to engage with the regulator and agree approaches will be extremely useful.

In the detail: Solvency II latest

Omnibus 2

The agreement in the trialogue and adoption of Omnibus II by the European Parliament is a massive step forward for Solvency II, and although the timeline for finalising delegated acts and implementing measures remains tight, there is now a much stronger commitment by all parties to achieve a 1 January 2016 implementation date.

Preparatory Guidelines

To help ensure both firms and their supervisors continue (or in some cases accelerate) their progression towards Solvency II compliance from 2016, EIOPA issued guidelines covering the key aspects of pillar 2 (internal governance, risk management and forward looking assessment of own risks (FLAOR)) and pillar 3 (reporting to regulators), as well as internal model pre-application process. These guidelines will apply from 1 January 2014 to Solvency II implementation date, and early indications are that most countries will adopt the majority, if not all, of the guidelines.

Implications for firms

Given these developments, insurers should revisit their implementation plans and consider what the guidelines will mean for their business, both now and from 2016. It will be important for firms to adopt a strategic approach to this, and develop an approach that will help them identify the business imperatives that need to be dealt with over the next two years, rather than adopt a solely compliance based approach.

Two key aspects need to be borne in mind throughout this preparatory period:

- The purpose of the guidelines is to assess both the ability of firms and their regulators to be ready for Solvency II on implementation date – it is not accelerating parts of Solvency II compliance.
- Firms need to apply the guidelines in a way that is proportionate to their nature, scale and complexity, focussing on the outcomes expected. In this respect, there are some additional requirements for the larger 'threshold firms', although this does not negate the need for smaller firms to consider how they will address these areas in due course.

Pillar 1

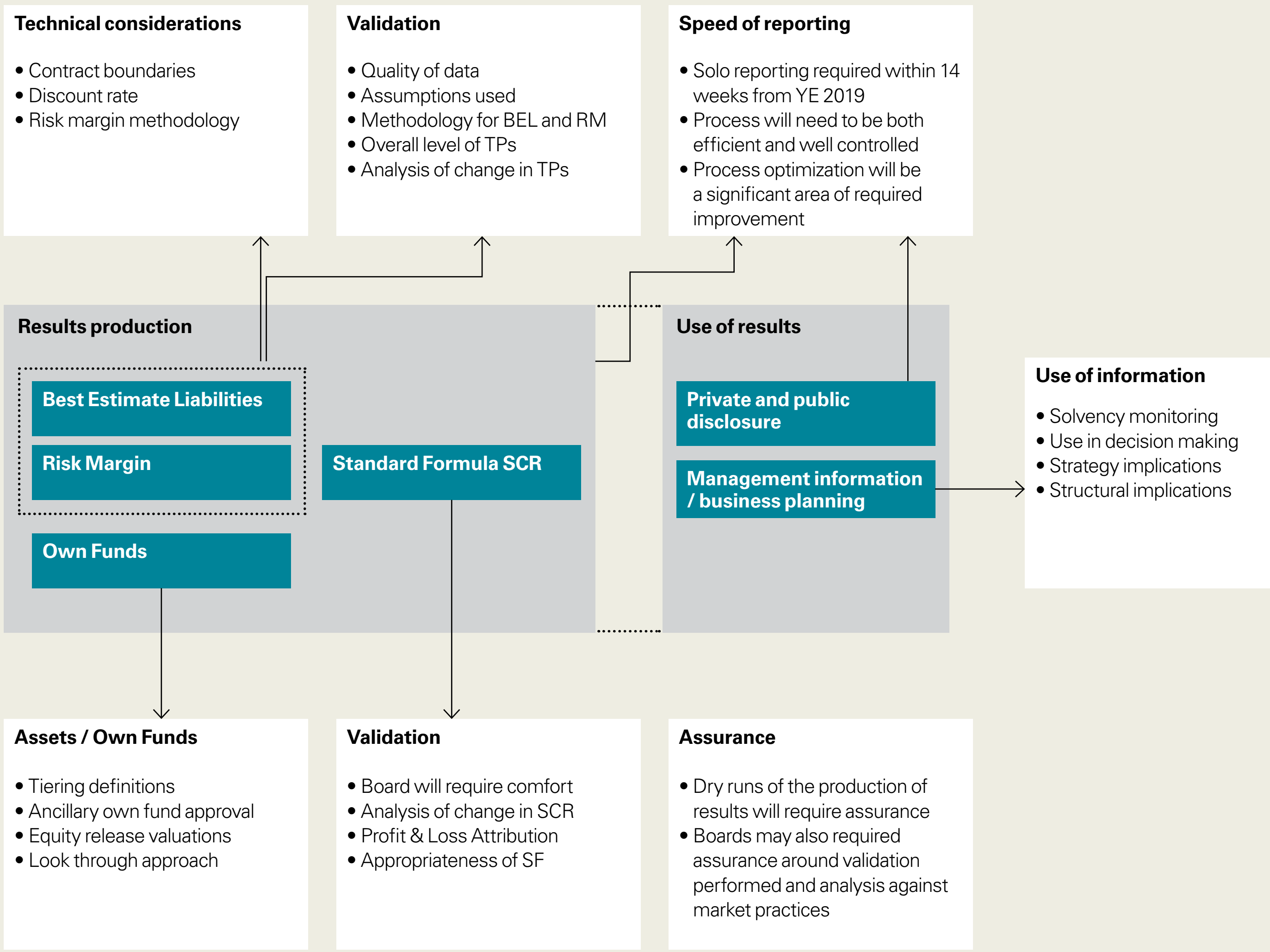
Outlined below is an overview of the key Pillar 1 considerations and the likely impact for insurers.

- Ensure all models are established and capable of producing the Pillar 1 technical provisions (e.g. Contract boundaries, discount rate curves, matching adjustment, risk margin).
- Understand which of the matching adjustment/volatility adjustment should be used for which products and whether the use of transitional provisions should be applied for – including consideration of the impacts and the reputational issues attached to using them.
- Understand what could be done with the assets that do not meet the matching adjustment requirements – determine if they can be restructured using, for example, SPVs.
- Ensure the governance process/controls environment around the technical provision and standard formula calculations are adequate enough for the purposes of publicly disclosed information.
- Determine how the technical provision and standard formula calculations can be independently validated.
- Understand the appropriateness of the standard formula to the company's risk profile so that it can be fully justified.
- Ensure that the Board has adequate assurance concerning the production and accuracy of the results.

An overview of the technical provisions and standard formula can be found opposite.

DATE	ACTIVITY	IMPACT ON INDUSTRY
August 2014	Draft Solvency II level 2 text is expected to be sent to the European Parliament for review.	The level 2 text comprises the draft delegated acts that provide further detail on the application of the rules. Insurers will need to incorporate these into their implementation plans.
November or December 2014	Parliament completes its review of level 2 text.	Final level 2 text will be adopted and published. *(Note: The period for approval of level 2 text could be extended to 6 months, if Council or Parliament raise objections, pushing this to February/ March 2015)*
Post-approval of level 2 text (contingent on timing of approval) but expected by early 2015	Decisions on equivalence/ temporary equivalence of non-EEA risk-based capital regimes.	Insurance groups with insurance operations located outside the EEA will need to consider the impacts on their group structure in the case of equivalence/temporary equivalence not being granted in respect of the jurisdictions where they have operations.
Quarter 4 – 2014	Consultation on draft implementing technical standards begins – ITS (level 3).	Insurers will need to consider how ITS impact the interpretations and application of Solvency II directive to their businesses. ITS are binding requirements and must therefore be built into insurers' plans.
31 March 2015	Deadline for member States to transpose Solvency II into national legislation.	National supervisors receive powers in advance of implementation date to enable them to start consideration of matters requiring supervisory approval, such as internal models, undertaking specific parameters, ancillary own funds, use of alternative method of group solvency calculation, etc. Insurers to determine those areas potentially relevant to them and when they will wish to submit applications.
Quarter 2 – 2015	First implementing technical standard expected to be endorsed by Commission.	First implementing technical standard expected to be endorsed by Commission.
1 January 2016	Solvency II implementation date.	Insurers are expected to meet all directive requirements, subject to application of transitional measures, and risk enforcement action in cases of breach.

PILLAR 1 – OVERVIEW OF THE TECHNICAL PROVISIONS AND STANDARD FORMULA



Source: KPMG International, March 2014

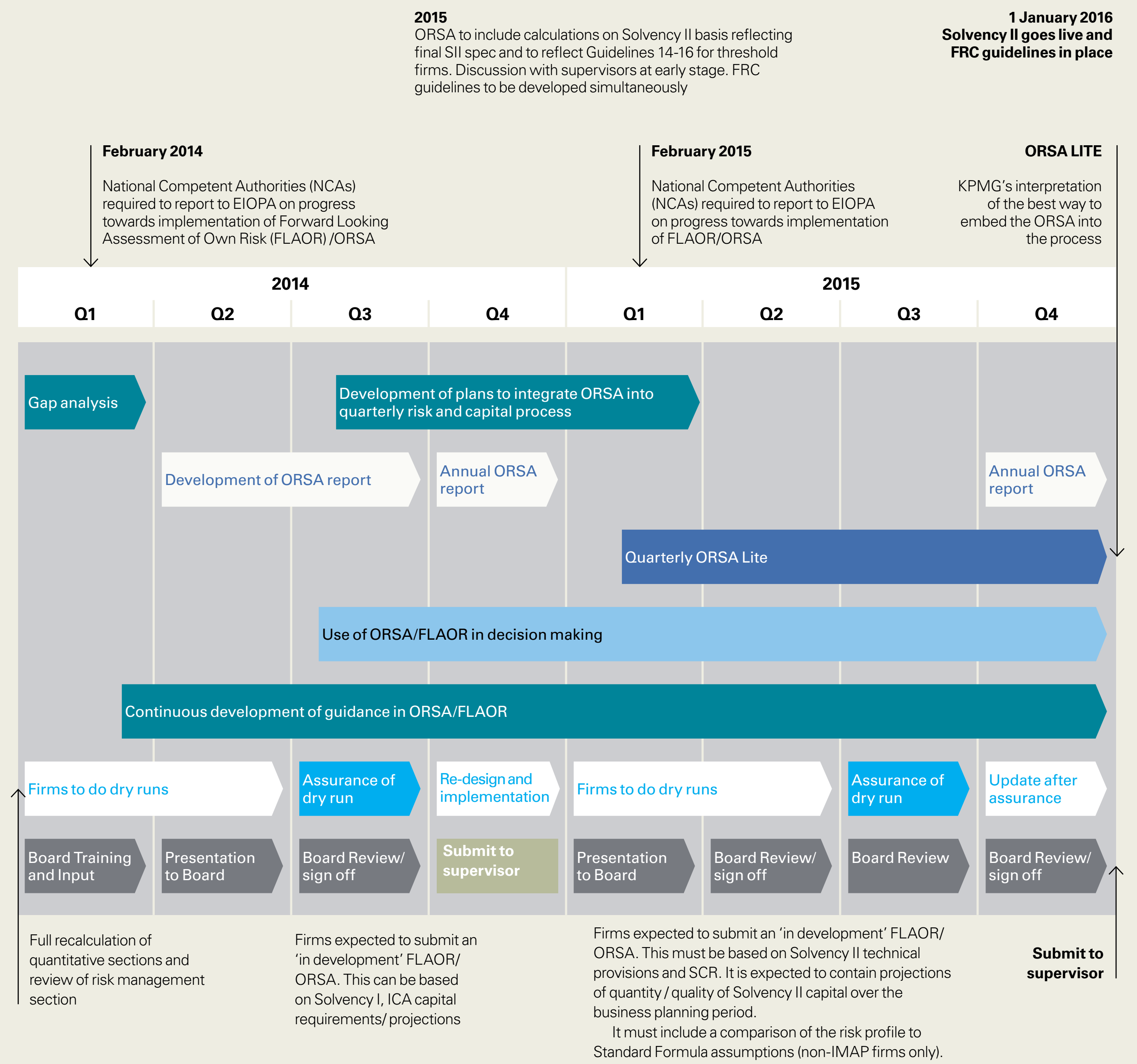
It will be important for firms to adopt a strategic approach that will help them identify the business imperatives that need to be dealt with over the next two years, rather than adopt a solely compliance based approach.

Pillar 2

In addition to Pillar 1 requirements, the Solvency II Pillar 2 requirements will also likely see significant effort being required by insurers. Outlined below are the key considerations and likely impact on insurers.

- Ensure you know early how developed your ORSA/FLAOR process needs to be in order to maximize business benefits and allow interaction with your supervisor.
- It will be essential that you can adequately demonstrate the use of the ORSA/FLOAR outputs in your decision making.
- It will be important to have sufficient assurance that your ORSA/FLAOR process covers the requirements and regulatory expectations and is sufficiently keeping pace with the latest changes and development.
- You will need to be able to properly incorporate ORSA/FLAOR requirements from subsidiaries into a Group view.
- You will be expected by supervisors to have the capability of projecting forward your risk and capital profile and know which areas may currently be proving problematic or may cause difficulties going forward (such as a need for better and more data analytics).
- Be able to fully understand the implications of the ORSA/FLAOR outputs on your strategy and risk appetite.

PILLAR 2 – ORSA TIMELINE



Source: KPMG International, March 2014

Pillar 3

A number of companies had de-prioritized pillar 3 reporting, and this gives renewed emphasis to this aspect of Solvency II development. The thresholds applying for pillar 3 reporting are shown in the table opposite.

It should be noted that the groups' application is restricted in this preparatory period to EEA groups/sub-groups only, with worldwide groups currently scoped out. These groups will need to assess the implications of the compromise reached on temporary and provisional (as well as full) equivalence on the potential scope of group supervision, and discuss this with their proposed group supervisor early in 2014 to enable them to develop their plans accordingly.

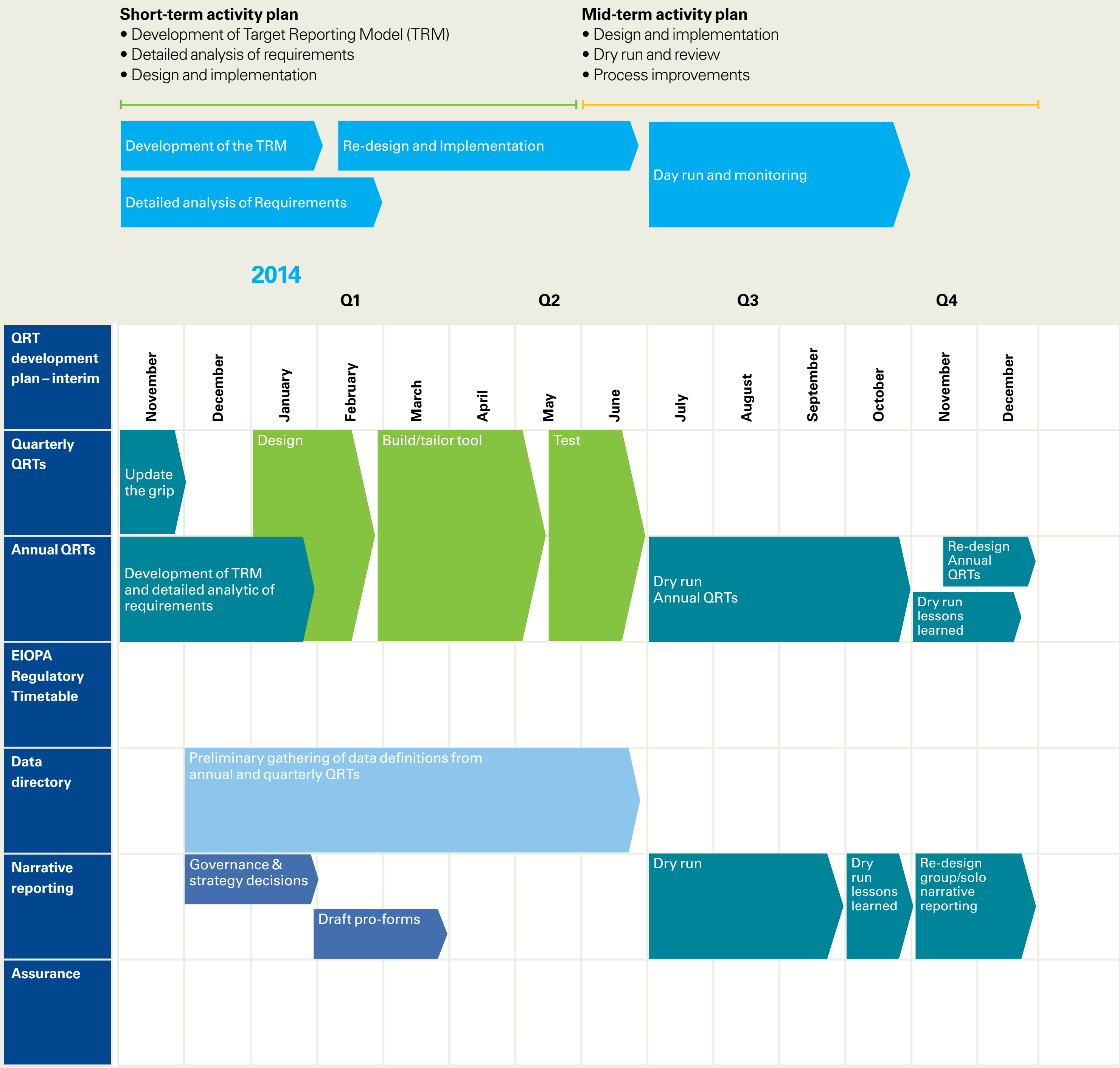
PILLAR 3 – THRESHOLD FOR REPORTING

	Annual and narrative reporting (GL 3, 12, 13, 17)	Annual and narrative reporting (GL 3, 12, 13, 17)
Life (solo)	Firms accounting for 80 percent of local market share by technical provisions	Firms accounting for 50 percent of local market share by technical provisions
Non-life (solo)	Firms accounting for 80 percent of local market share by gross non-life premiums	Firms accounting for 50 percent of local market share by gross non-life premiums
Groups	Total assets > €12 billion	Total assets > €12 billion

PILLAR 3 – KEY CONSIDERATIONS AND LIKELY IMPACT FOR INSURERS

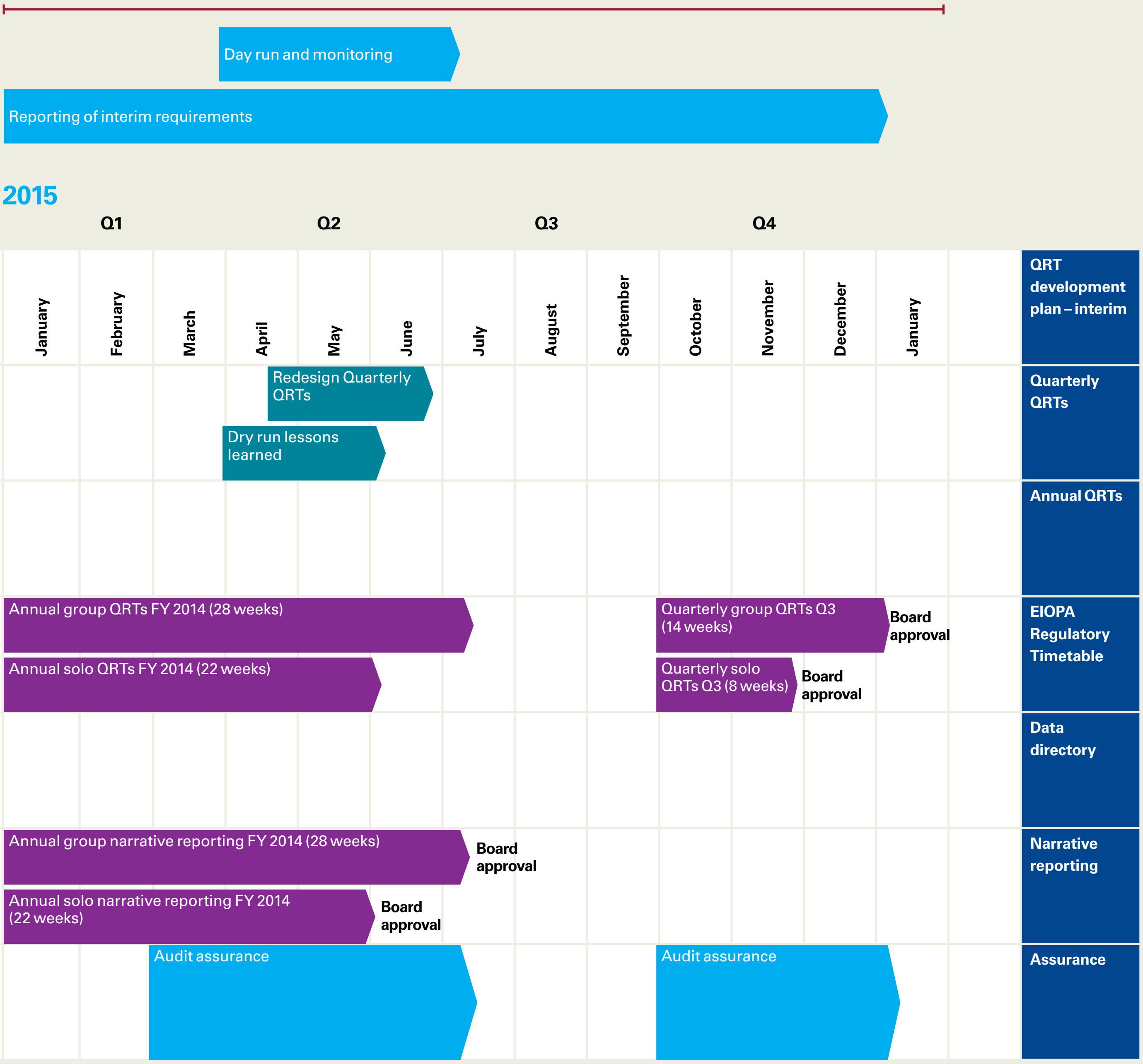
Key Questions	KPMG perspective
How do we deal with the pressures of the reporting requirements and extract value from any spend?	Companies should take time to build into their plans what they want their future overall financial and risk reporting capability to look like. We believe those who show a greater appetite for change now, rather than focussing on Solvency II compliance, will extract the most value in the future – and will derive real enhancement in the quality, timeliness and relevance of reporting. As companies get into the details of the requirements, we are seeing workstreams expand to cover alignment of current financial reporting with planning for IFRS 4 Phase II.
What will quarterly reporting mean to us?	Companies need to produce reliable and accurate numbers on a quarterly basis and to a rapid timescale. Any decision to prepare on an estimated or hard-close and roll-forward basis will need to be tested internally and is likely to be a matter for discussion with the regulator. For many, the move to quarterly reporting will prove to be the trigger for significant process and system change and, for some, it will be a fundamental cultural shift from the current once or twice a year reporting cycle.
Do we understand what will be disclosed about our organization in addition to what we do currently?	For some companies, Solvency II represents a significant increase in the publicly-disclosed information about the business, including detailed information about the source of profits, capital requirements, including any capital add-ons, and reinsurance arrangements. Senior management should engage early with the workstream to understand what information is going to be disclosed.
How do we deal with the increased granularity of reporting?	The current guidance requires asset data to be disclosed by individual security for quarterly reporting to the regulator. While there is significant resistance from the industry on this, the PRA has been clear that this level of granularity is key given the Solvency II balance sheet is more realistic than current PRA returns. Companies should prepare for the worst case scenario and decide at what point they begin implementing the requirement.
How do we ensure the numbers we are producing are sufficiently high quality?	Boards will need to be confident that the Solvency II information they are being provided with is appropriate to disclose to the public, submit to the regulator and use for internal decision making. This will involve assurance around the policy, methodology, systems and controls used to produce the numbers.

PILLAR 3 – HIGH LEVEL SHORT/MID/LONG-TERM ACTIVITY PLAN



Source: KPMG International, March 2014

Long-term activity plan
• Interim reporting requirements
• Assurance
• Commercial challenges around new metrics disclosed



Middle East

Regulatory change is beginning to occur in the Middle East. The transfer of insurance sector regulation in the State of Qatar to the Qatar Central Bank (QCB), with an aim to enhance and modernize insurance sector regulations in the State, is a significant development for the region. Shari'a-compliant insurance products such as Takaful continue to dominate the landscape in the Middle East region. In particular, development in the Shari'a compliant products has been most active in the United Arab Emirates, where in the Emirate of Dubai, the Retakaful industry has been identified as one of the sectors to be developed under Dubai's Islamic Economy Strategy, which aims to turn the Emirate into a global Islamic hub.

In other noticeable developments for the region, the Central Bank of Bahrain and Qatar Financial Centre Regulatory Authority (QFCRA) introduced new sets of regulations which are outlined in this chapter.

BAHRAIN

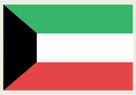
Bahrain continues to be a major financial center in the Gulf and has leading Takaful (and retakaful) players of the market growing reasonably quickly, registering a year on year growth of 22 percent from 2011. Further, the insurance industry overall in Bahrain continued to grow during 2012 (latest year of available data) by registering a growth in gross premiums of 9 percent in particular in Motor and long-term businesses. Market participants remain optimistic for continued strength growth in 2014.

Bahrain's solvency capital framework is not yet risk-based and there has not been any significant development yet by the Central Bank of Bahrain (CBB) to introduce new risk-based capital, ERM or valuation standards as required by the IAIS Insurance Core principles.

During 2013, the CBB issued proposed amendments to the CBB Rule Book Volume 3 which is mainly focused on the Takaful and Retakaful sector with certain implications on the wider insurance sector such as requirements for Financial Condition Report (FCR). The proposed amendments are expected to be effective in 2014. The key changes to the Rule Book, impacting Takaful/Retakaful sector, include a requirement for firms to inject capital and notify the CBB immediately if capital falls below the minimum fund, prohibition of performance fees and variable wakala fees for the Takaful Operator. Furthermore, all firms will now be required to submit Financial Condition Report (FCR) at least annually to the CBB which heralds change in the supervisory approach of the CBB. The proposed Rulebook prescribes detailed requirements of the FCR.

Shari'a-compliant insurance products such as Takaful continue to dominate the landscape in the Middle East region.

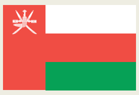
KUWAIT



Kuwait is the only remaining GCC country without an independent Insurance regulator, however there are discussions underway to set up an independent insurance supervisor and modernize insurance regulations. Kuwait is also the only IAIS non-member in the GCC. The life insurance sector continues to experience slow growth and low penetration.

'Vision 2035', the State of Kuwait's national development plan is expected to enhance insurance demand in the coming years. The Plan is aimed to transform Kuwait into a financial and commercial hub attracting investments. It is also expected that Kuwait will establish an independent insurance supervisor and modernized insurance regulations as part of reforms and development plans.

OMAN



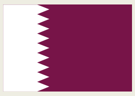
The Duqm Special Economic Zone development and the proposed railway project in Oman have caught the attention of the insurance market, as being developments which could create valuable opportunities for the sector.

Outside Oman, Takaful firms have a 33 percent share of the total underwritten premium in GCC region. Oman is expected to achieve similar underwritten premium once the Takaful firms start operating. A strong growth opportunity is expected if neighboring GCC countries are taken as an indication.

The Islamic banks and Islamic windows[19] of conventional banks have started operating in Oman under Islamic Banking Regulatory Framework (IBRF) issued by Central Bank of Oman. Under IBRF the new Islamic banks and windows of conventional bank need Takaful solutions to support their financing, and as a result, the demand for the Islamic insurance products is expected to increase.

The Capital Market Authority (CMA) has issued three interim licenses to Takaful companies and the draft law by the CMA has been finalized, which allows only fully fledged Takaful companies to operate in the Sultanate with minimum capital of OMR 10 million (unlike window operations in the banking sector). New law prohibits conventional insurance companies to operate Takaful business unless they are fully converted into Shari'a compliance together with meeting regulatory and licensing requirements of the CMA. The CMA is in the process of finalizing the Takaful Law, which will be formalized, upon finalization by the CMA pursuant to a Royal Decree.

QATAR



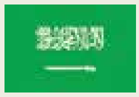
The most significant development in the State of Qatar has been the transfer of Insurance sector supervision in the State of Qatar to Qatar Central Bank (QCB). This is a significant change given insurance sector in Qatar has been mostly unregulated and this is a step in the right direction. The QCB is currently developing regulations and have required all entities conducting insurance business in the State to register their intent to seek a license from the QCB.

The Qatar Financial Centre Regulatory Authority (QFCRA) is continuing its efforts to align Qatar with international practice – with the development of RBC continuing to be a primary goal. QFCRA issued a new set of prudential rules for insurance firms operating from the Qatar Financial Centre (QFC), to be applicable from 1 January 2015, based on risk-based capital. The new rules enhance the QFC regulatory framework, particularly in the following areas:

- capital adequacy – improving risk sensitivity of the Prudential Insurance Rulebook (PINS) risk-based capital model, by creating insurance concentration and operational risk requirements, and by streamlining and recalibrating other risk components of the prudential capital framework;
- enterprise risk management – strengthening the risk management framework by requiring an insurer's governing body to be involved and approve an annual risk and solvency self-assessment;
- valuation – enhancing the rules and guidance relating to actuarial techniques, methods and assumptions used to value assets and insurance liabilities;
- investments – improving the management of investment risk by insurers through the establishment of asset-liability matching requirements, investment concentration limits, asset admissibility criteria and by introducing a prudent person principle; and
- insurance groups – expanding supervisory powers for the QFC Regulatory Authority relating to requests for additional information from insurers who are members of a group.

Overall it should be noted that the insurance sector in Qatar have welcomed the developments in enhancing insurance legislation in the State and the modernization of insurance regulations being at par with global standards.

SAUDI ARABIA



The Saudi Arabian insurance industry has seen growth, mainly owing to consistent economic expansion within the Kingdom of Saudi Arabia. The number of players; the mode of distribution; the regulatory developments; technological improvements; and healthy economic growth have all propelled the industry forward. In this regard, the main catalyst for the growth of the sector has been the rise in compulsory lines i.e. health and motor insurance. Despite the positive growth, the market participants are facing challenges to maintain market share and profitability mainly owing to increasing claims expenses; mixed investment earnings; and pricing pressure due to strong competition as participants try to manage and maintain market share with less focus on profitability.

The Saudi insurance sector comprises 33 companies, with a small number of companies licensed by Saudi Arabia Monetary Authority (SAMA) which are likely to start their operations in the near future. The sector has witnessed strong growth of approximately 30 percent over last couple of years mainly due to growth in compulsory lines. Going forward, it is expected that in line with the increase in the Government's capital spending on infrastructure, education, healthcare and engineering projects the insurance sector will have the opportunities to further align its growth. Notwithstanding the growth in recent past, it is important to reiterate that the insurance companies are facing significant challenges to maintain their market share and long-term profitability.

19. A 'Window' refers to where there is a Shari'a compliant operation within a conventional financial institution.

UNITED ARAB EMIRATES (UAE)

UAE accounts for 44.1 percent of the GCC region's GWP in 2012. It expanded at an annual average growth rate of 9.6 percent between 2008 and 2012 to reach a size of US$ 7.2 billion. Although the UAE has one of the most developed life insurance markets in the region, the non-life segment continues to contribute the bulk of the industry premium. However, in the recent years, growth rates of the life insurance segment have been notably higher than that of the non-life segment.

A number of key factors are driving this growth:

- Demographic factors: Population growth of around 3 percent between 2012 and 2017 is expected to be a major factor driving growth of the insurance industry in the UAE. High proportion of expatriates and an ageing population also bode well for the medical and life insurance segments, in particular.
- Personal income: The UAE has one of the highest levels of GDP per capita in the Middle East. General income of the residents is forecast to expand further, thus increasing their likelihood of investing in insurance.
- Business climate: The UAE has investor friendly government policies and a stable political climate, suitable for attracting large investments in infrastructure and business activities. This provides an expanding base of insurable assets.
- Compulsory lines: Similar to Abu Dhabi, medical insurance is expected to be made mandatory in Dubai and other Emirates in the future. New vehicle sales in the country are projected to expand at a compound annual growth rate of 9 percent through 2017. These factors are likely to support demand for health and motor insurance products respectively.
- Takaful market: Islamic insurance is also contributing towards higher awareness and acceptability of insurance products in the UAE.

Other key developments this year have been the unveiling of Dubai's Islamic Economy Strategy, with Retakaful as a key pillar to turn Dubai into a global Islamic finance hub. The strategy is comprehensive, structured around all sectors and developed by Dubai's Supreme Committee of Islamic Economy.

With Solvency II now certain to move forward, the supervisory approach across the CEE region is increasingly moving towards risk-based supervision, with supervisors assessing the risks within firms and their potential impact on the markets.

Central and Eastern Europe

The Central and Eastern Europe (CEE) region covers 18 countries of different sizes with diverse market and economic development. In particular, many countries have followed a similar path – firstly transitioning from centrally run socialist regimes, some to then passing through EU accession while transposing EU laws, while others have reached a 'mature' phase in their development accommodating EU integration. The EU presence in the region has recently strengthened, due to accession of Croatia on 1 July 2013.

As a sign of the maturity of both the legal and economic environment, some of the countries are revisiting **the fundamentals of their civil law**. For example, a new Civil Code has been adopted in the Czech Republic and Hungary while Slovakia is likely to adopt a new code during 2014. Taking the example of the Czech Republic, the new Code shifts the culture of the society from one that was centrally driven towards a new environment which provides greater emphasis on the freedom of individuals.

These newly introduced Codes have important implications from an insurance perspective. For example, the changes are resulting in a move away from a traditional compliance focus, to one of self governance and responsibility such as strengthening internal governance (processes, responsibilities), business model (review of selling processes, dealing with client issues during the product development phase and claims handling) to reviewing current terms and conditions of every product a firm offers. This cultural shift brings also a secondary effect – a greater protection of weaker parties to contracts. The CEE region is therefore experiencing the progressive **introduction of conduct of business regulation**. For instance, Slovakia is drafting a new law on consumer protection and even considering the creation of a new supervisory body to oversight. Poland has incorporated compliance reviews related to market conduct into their new supervisory approach and have taken a number of concrete steps to further strengthen customer rights. The growing importance of policyholder protection/conduct of business regulation is clearly visible across the region. However, national regulations and practices vary significantly with a number of different agencies and authorities involved.

In terms of **supervisory practice**, the region saw some more integration taking place – the most recent **mergers** of supervisory authorities occurred in Hungary (the financial market supervision integrated within the Central Bank of Hungary) and in Romania (newly created integrated supervisory authority Autoritatea de Supraveghere Financiara for insurance companies, capital markets and pension funds) at the end of 2013.

With Solvency II now certain to move forward, the **supervisory approach across the CEE region** is increasingly moving towards risk-based supervision, with supervisors assessing the risks within firms and their potential impact on the markets. The most transparent and advanced example is the Polish Financial Supervision Authority (Komisja Nadzoru Finansowego), which prepared its own 'BION' (Badanie i Ocena Nadzorcza – Supervisory Review and Assessment) – a methodology to prioritize the focus of the supervision on firms depending on their risk profiles. Other countries are adopting other measures, one such example being Early Warning Indicators in Romania. Some of the CEE supervisors (such as Poland and Croatia) ran national Quantitative Impact Studies to test the impact of the latest Solvency II requirements on their national markets. It is clear that as the approach of the supervisory authorities becomes more risk-based, insurers will have to be prepared for a more focused, proactive and demanding interaction with regulators.

In addition, **the EIOPA preparatory guidelines are gaining momentum** across the region and are considered by supervisors as a good preparatory exercise. From the disclosed responses of supervisory authorities, the vast majority of them are intending to comply with the new guidelines and will apply locally to their respective insurers. However, the specific steps, requirements and timetable of implementation for most supervisors remain unclear. In the Czech Republic for example, the supervisor published a detailed schedule of when and what will be required during the upcoming two years which led to a lively debate with the industry. The implication for insurers is that Solvency II preparedness should commence now given supervisors across the region will increasingly begin to expect substantial implementation of the new requirements. Importantly, it is also advisable for insurers to begin engaging in good dialogue with their supervisory authorities as soon as possible to have a clear picture of what is expected from them.

South Africa

Regulatory solvency capital and risk management update:

Early in 2013 the Financial Services Board (FSB) announced a delay in the effective date of its Solvency Assessment and Management (SAM)[20] framework to 1 January 2016. In order to facilitate transition to the new regime, the initial plans for implementation were amended to consist of a 'light' parallel run in the second half of 2014 and a 'comprehensive' parallel run in 2015. The comprehensive phase would consist of the completion of a full set of quantitative reporting templates along with a mock Own Risk and Solvency Assessment (ORSA) exercise.

The parliamentary process for getting the legislation in place resulted in a delay in the planned implementation of the Insurance Laws Amendment Bill (ILAB). This bill, if adopted, will amend the current insurance acts to more strictly regulate governance, risk management and internal control measures.

The industry's self assessment in response to the FSB's Pillar II readiness survey indicated that compliance with certain requirements for boards of directors, the outsourcing directive, and ORSA, were the major challenges.

The results of the second quantitative impact study (SA QIS 2) showed a healthy 27 percent increase in participation from insurers. By premium volume, 98.5 percent of the South African industry was covered. The results also showed that for life insurers, there was very little difference in the overall free surplus under SA QIS2, compared to that under the current position. For non-life insurers, the capital requirements increased substantially.

The third and compulsory quantitative impact study (SA QIS3) is currently in progress and the closing date for submission is April 2014.

The FSB has also launched a separate study to analyse the potential impact of the implementation of the SAM framework on economic growth under various scenarios.

South Africa has applied for temporary equivalence under Solvency II.

20. A risk-based solvency framework that would comply with the criteria for Solvency II third-country equivalence, whilst accommodating the unique requirements of the South African insurance industry.

The changing approach of insurance supervision to risk management

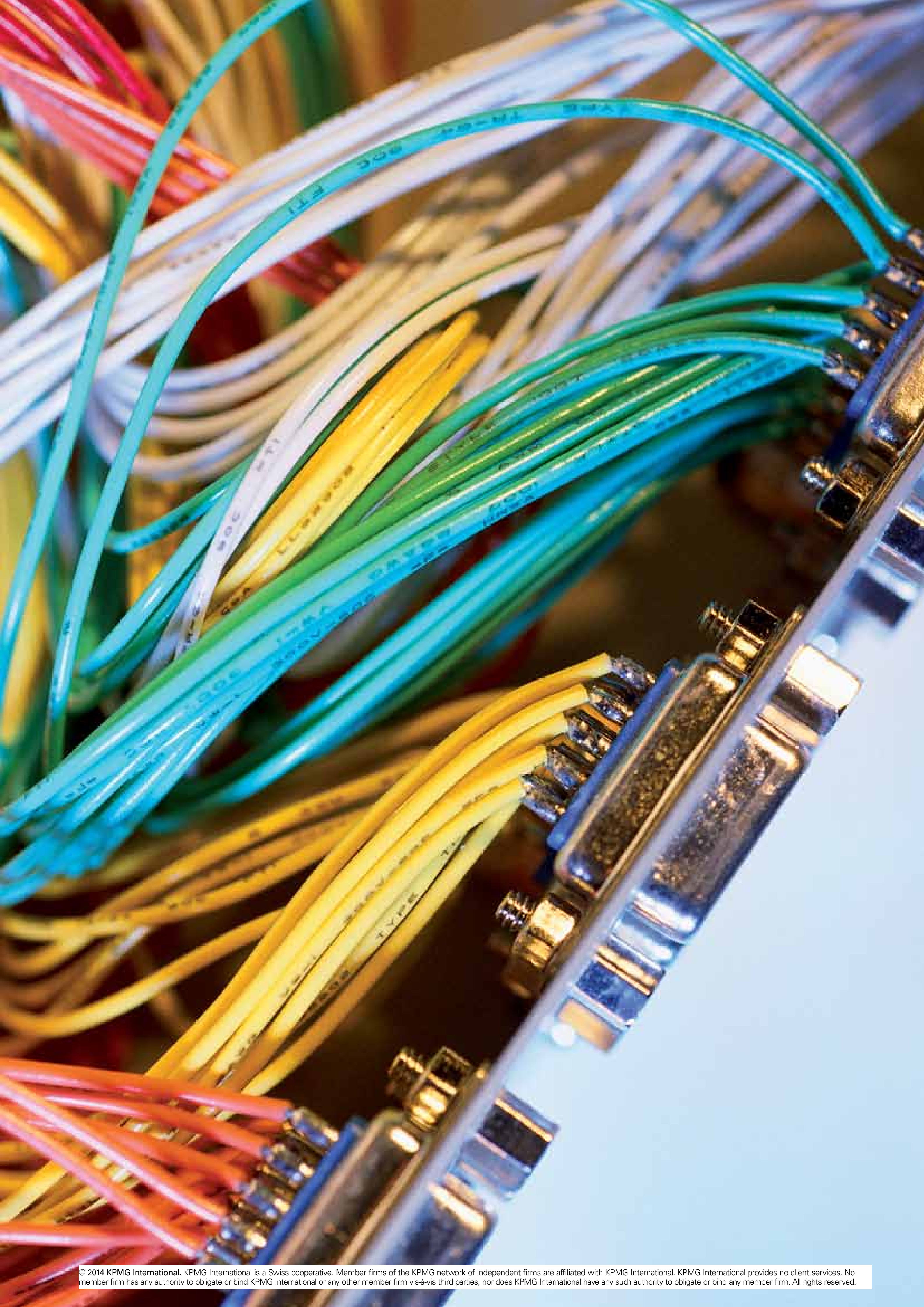
Over the last 12 months, there has been a growing trend of supervisory authorities announcing intentions to merge insurance supervision within existing central bank functions. Such moves are likely to alter the focus of insurance supervision going forward with an approach that is likely to be more 'bank centric' in its methodology which will likely change the way supervisors will monitor the risk management activities of insurers. Outlined below are a number of likely changes expected and what this could mean for insurers.

One of the most significant changes expected, based on how bank supervisors have now begun to alter their roles and focus, is a greater emphasis in understanding the business and operating model of the supervised firm, particularly concerning capital (especially with regards to access and quality of capital) and liquidity needs. There is also very likely to be an increased focus on group structures with regard to the overall risk governance, accountability and management of risk across the organisation. In this regard, culture is increasingly becoming a major area of review, especially now that supervisors have learnt the lessons post financial crisis where poor management decisions and accountability were considered to significantly contribute to poor decision making. Such lessons have also meant that supervisors have adapted their supervisory tools and models to be much more willing to intervene in management/board governance matters and use predictive analysis tools to monitor forward solvency positions.

Business and operational model

Across sectors, the sustainability of a firm's business model is now much more the central focus of supervision – a trend very likely to impact insurers in most jurisdictions. Of particular interest for supervisors is the ability of the insurers to withstand future stresses on its capital position, and what impact this may have for the insurer's long-term capital requirements and viability as a going concern. Increasingly, it should be expected that such supervision will become more 'prudential' in nature (renewed emphasis on capital, risks and management rather than from the customer and fairness perspective). The latest G20 and IAIS announcements, especially concerning the creation of a global capital standard and related focus on systemic issues and backstop capital requirements provide a strong signal of this likely direction of focus for insurance supervisors over the next few years.

This increased scrutiny will likely require insurers to better demonstrate the impact of



business decisions on overall risk-adjusted profitability, and the ability of the entity and group to meet forward solvency and liquidity needs, including the reinsurance program selected. The importance of appropriate stress and scenario tests and the application of such analysis, particularly concerning tail events and resultant impact/mitigants this may have for the ability of the insurer to finance future growth, are expected to be a major focus of supervisory questioning going forward for most insurers. The feasibility of the movement of intra-group capital and the resilience of subsidiary capital positions on a stand-alone basis is also going to form part of this increased scrutiny.

Of particular interest for supervisors will be the forward-looking assessment of own risk (FLAOR) which has replaced the Own Risk and Solvency Assessment (ORSA) terminology.

The FLAOR is designed to be an assessment of a firm's previous, current and future risk, strategy and capital position. However firms, understandably, are finding it difficult to project their future risk profile over the life of the business plan; an area in which regulators, ratings agencies and the market are increasingly looking to gain comfort.

Of particular challenge for insurers is their ability to anticipate how current risks will evolve over the life of the business plan (e.g. firms in run-off in particular becoming more exposed to expense risk or firms that turn to alternative assets having increased market risk exposure in a low interest rate environment) as well as identifying any emerging (new) risks that may be on the horizon. Most forward looking risk analysis has tended to focus on regulatory risks with no distinction between external and internal risks, and often limited analysis of the underlying risk which might drive regulatory change.

In addition, while capital models use mathematically complex correlations to predict interactions between individual risks, there is frequently a lack of analysis on how this will change over the life of the business plan. Supervisors will expect to see development in the sensitivity analysis applied to correlations when assessing the future risk profile; in turn providing a tool to drive decisions over investment of surplus capital and optimization of return on existing capital.

The dynamic analysis of the ORSA / FLAOR is shown below:

In a further sign of the changing regulatory landscape, many supervisors are now moving to a formal quarterly reporting process to allow for the regular capture of

Supervisors are becoming more willing to intervene in the critical business decisions of regulated entities and insurers could expect similar scrutiny.

ORSA / FLAOR DEVELOPMENT AREAS

PROCESS DESIGN & EFFECTIVENESS
- Development of a quarterly process
- Integration – multi-disciplinary requirement
- Frequency – metrics
- Robust – also ability to re-run the process post material changes
- Demonstrating embedding of the ORSA

ARTICULATING THE FUTURE RISK PROFILE
- How is the risk profile evolving
- Solvency projections
- Strategy and Business Plan link
- Changes to correlations
- Stress tests and Sensitivity analysis
- Emerging risks

RISK COMPONENT DEVELOPMENT
- How are Group Risk and Conduct Risk incorporated:
  - Intra-group exposures / non-insurance entities
  - Conduct Risk: Customer targeting, Back book analysis; quantification of conduct issues

ORSA COMMUNICATION/ DISCLOSURES
- What are the expectations of investors and external stakeholder (including ratings agencies)? –how can the ORSA / FLAOR facilitate this?
- Opportunity to differentiate by exceeding minimum compliance
- Credit for good risk management

Source: KPMG International, March 2014

decisions using ORSA/FLAOR risk and capital data, e.g. changes to risk appetite or pricing, and Boards will be expected to drive progress in this area. Such changes then allows the full annual ORSA/FLAOR to focus on strategic inputs to the business plan and associated decisions.

Supervisors are also expecting greater quantification of conduct risk analysis to be included in the ORSA/FLAOR, particularly in regards to how such risks interrelate with the insurer's business plan, pricing and reserving.

Further, greater disclosure of an insurer's risk and capital profile and what this means to the quality of capital they hold, liquidity and ability to pay dividends is also on the regulatory agenda. However, it is also of great interest to investors and rating agencies. An increased level of transparency is likely to bring more confidence to investors particularly after a period of pressure on capital, earnings volatility and concerns around the sustainability of some firms' business models.

All stakeholders are now increasingly examining the Executive team's oversight of their risk and capital profile to ascertain if it is consistent with the business plan enabling third parties to distinguish between those who optimize risk and capital management and those that merely look to tick the compliance boxes.

Good practice in ORSA/FLAOR analysis is now that insurers should not be satisfied with merely producing a report that complies with the regulation, but be continually asking themselves how they gain and bring deeper insights to their key stakeholders demonstrating the robustness and adequacy of the business strategy and plan.

Capital

For bank supervisors, the adequacy of capital has always been a cornerstone of their supervision. The same level of intensity has not necessarily applied to insurers given the very different business models between the two sectors, evidenced by liquidity concerns which have been more heightened in banking traditionally than in insurance.

However, the financial crisis did at least begin to question such paradigms and the increasing merger of insurance supervision into central banks is witnessing a renewed focus on capital and the quality of capital resources. The growing trend from supervisors has been to analyse an insurer or group's capital sufficiency over a five to ten year horizon period rather than the 1 in 200 point estimate used for regulatory capital calculations. Supervisors are increasingly examining the actual economic capital needs of the organization and the interplay with commercial imperatives such as rating agency assessments and subsequent market reaction and sentiment, rather than relying solely on traditional regulatory capital measures. The introduction of the US ORSA requirement from next year is a good example of the substantial change in focus that will occur notwithstanding the changes that have been made as part of the Solvency Modernization initiative (SMI) program.

Supervisors are also becoming more willing to intervene in the critical business decisions of regulated entities and insurers could expect similar scrutiny, for example:

- Greater need to demonstrate the sufficiency of the overall capital management planning and governance arrangements in place;
- More detailed analysis concerning stress and scenarios, management actions and the resultant impact on capital and solvency positions on the business and across the group. This includes development of the impact of resolution events;
- Greater expectations on Board and senior management to understand more intimately capital flows and related investment decisions, particularly concerning non-traditional, non-insurance activities; and
- Some regulators are even introducing more pre-clearance requirements whereby they provide a 'no objection' position on issues such as the setting and release of dividends.

Risk governance and culture

The global financial crisis highlighted the weaknesses of many insurers' risk governance and risk management frameworks. Insurance supervisors cited a number of shortcomings, notably:

- It was not clear who within the insurer had responsibility for risk management;
- The risk management function was often under-resourced and/or poorly qualified to perform the role;
- Often one individual had multiple roles, such as the CRO, the CFO and the Approved Actuary for managing risk and making decisions;
- Poor Board oversight and direction with an over-reliance on senior management and actuaries
- A risk culture was not embedded within the organisation;
- Risk appetite statements and tolerances were not clearly articulated or linked to business strategy and performance;
- Key Performance Indicators of Individual's were not linked to the performance of risk management;
- There were deficiencies in risk monitoring, reporting and controls; and
- A culture of compliance existed towards risk management generally.

Supervisors are increasingly examining the actual economic capital needs of the organization and the interplay with commercial imperatives.

Foundation	Transformation
Clear accountability with authority • Establish clear lines of responsibility and accountability for the key risk and control decisions or processes in the organisation	**Enhanced role for the risk and compliance function** • Define and implement the role of the 'Trusted Advisor' (business partner) in the Risk and Compliance functions • Give Board-level access
Communication and engagement • Develop a high impact communication strategy that reiterates the importance of good risk management • Develop MI that supports the framework	**True ownership of risk in the first line** • Line managers to emphasize and re-enforce the importance of good risk and control behaviors • Staff take accountability for the risk they manage
Leadership and direction • Ensure that the role of risk and compliance is clearly articulated in the strategy, vision, mission and values • Challenge/demand risk-related information	**Break the culture of fear** • Create an environment of openness where escalation of issues is actively supported • Leadership to act as role models
Capability development • Train front line staff to identify and mitigate risks • Tailor technical and professional training to be more risk and compliance focused	**Engage your people in creating the change** • Get your staff to provide their views on the current culture through online forums, panels and on-going conversations
	End to end view of risk • Develop end-to-end risk processes with end-to-end Management Information

Few organisations have successfully changed risk culture holistically, and for the insurance sector, changing culture remains a key challenge because too often they employ established program techniques which often fail to capture the right measures.

To address these issues, supervisors have increasingly reached the conclusion that establishing a strong risk culture is an essential element of good risk governance and that if they are to 'stay ahead of the curve' in undertaking their roles, than a reassessment of how they oversee risk management is required.

Consequently, supervisors have begun to set new risk management expectations for insurers, for example:

- Establishing more risk-sensitive capital regimes to better strengthen and link risk management to the capital needs arising;
- Introducing stress and scenario requirements, including resolution, or strengthening such requirements where these already exist;
- Expecting remuneration policies for senior Executive personnel that encourage behavior that supports the risk management framework and long-term financial interests of the firm;
- Requiring a clearly articulated risk appetite statement which is clearly embedded within the insurer's operations; and
- Demanding better assessments regarding the suitability and adequacy of the insurer's risk management framework, including ongoing appraisal of the insurer's risk culture.

Importantly, supervisors are now increasingly examining the behaviors and not the structures which exist and are firmly of the view that high quality risk management requires effective risk governance. This is particularly evidenced by the standards and expectations set by the Board which invariably have a significant impact on the culture and the management of the insurer. Very often it is these elements which determine the quality of risk governance.

However, few organisations have successfully changed risk culture holistically, and for the insurance sector, changing culture remains a key challenge because too often they employ established program techniques which often fail to capture the right measures. For example:

- They are anxious for outputs and deliverables that drive activity but not real meaning;
- Activities are too focussed on the short-term and are profit rather than risk-oriented;
- Collect lots of information but mainly information that is an expression of what people are happy to say, not what they actually believe and do;
- Focus more on mechanisms (e.g. reward structures) than behavior and beliefs;
- Are too broad in their focus (i.e. even defining culture can be time consuming); and

- Are internally focused and do not explore the experiences of external groups (customers, regulators, former members of staff).

A good risk culture is therefore necessary to guide and limit individual and group behavior and an insurer's risk culture is best understood by evaluating the appropriateness, adequacy and effectiveness of its risk management practices. In essence, a culture of risk ownership is one where there is:

- A well executed risk management strategy;
- Leaders that role model good risk and compliance behavior;
- Performance management and reward systems that drive and reinforce compliance;
- A risk function that is aligned and engaged with the business; and
- All members of staff understand accountabilities and consequences.

The implications for insurers are twofold. First, they need to establish structured MI and interventions that can build the foundation elements of a good risk culture. Second, they then need to employ transformational activities that create a strong risk culture in accordance with the organisation's ambition. This is outlined further in the table on page 68.

More macro surveillance activities

One of the lessons learned from the financial crisis was the need for supervisors to undertake more macro surveillance and analysis concerning the state of the industry with regards to aggregate solvency and capital levels, and in particular, entity specific cash flow generation and balance sheet structures.

As a result, supervisors are using more data requests outside the usual quarterly or annual return cycle to seek information such as pricing approaches and methodologies used by insurers, asset model valuations parameters and inputs, sufficiency of control and governance arrangements over reserving calculations and extent of third party vendor and outsourcing activities. The introduction of prudent person principles, such as in Solvency II, will also likely incur for insurers greater supervisory attention.

The greater focus on macro-economic issues is now changing how supervisors interact with the industry. For example:

- Using 'forward-looking' information to augment their usual 'point-in-time' data analysis;
- Introducing new system-wide metrics and requirements (such as those planned for G-SII's) to ascertain potential build-up of risks;
- More frequent and extensive interaction with Boards;
- The need for supervisors to have a variety of reference points when assessing the financial condition and capital position of insurers; and
- The introduction of Early Warning Indicators to assist in determining the robustness and sufficiency of insurer's internal model output.

Collectively, these initiatives will result in supervisors adopting a much more judgement-based style of supervision going forward, with the confidence and preparedness to intervene pro-actively particularly in matters concerning capital, risk and governance.

In our view, practical actions for insurers are:

- Undertake appropriate horizon analysis to ensure your existing risk assessment methodology is capable of identifying potential new risks and understand how this could impact upon your strategic objectives;
- Ensure that you have the capability to properly integrate your risk appetite metrics, risk management strategy and overall strategic business objectives;
- Have multiple risk and capital tools that can assist you undertake better analysis of the dynamic risk environment in which you operate;
- Begin to integrate conduct risk considerations into your ORSA/FLAOR assessment to ascertain the impact on the business plan, pricing and reserving;
- Instil the right risk governance behaviors across the organization to enhance your risk culture; and
- Be well prepared and able to identify the emerging trends in insurance supervision to better understand how your risk management framework can respond.

Supervisors are now increasingly examining the behaviors and not the structures which exist and are firmly of the view that high quality risk management requires effective risk governance.

IASB moves towards an international standard

With the completion of the International Accounting Standards Board (IASB) consultation on the Insurance Contract exposure draft, there are still several unanswered questions.

- **What are the effects of the forthcoming standard on profit recognition and how are product design, investment strategy and reinsurance programs impacted?**
- **What accounting options and judgements are available, and how will they be applied – compared to other market participants?**
- **Do new financial performance indicators need to be defined, in particular to measure performance internally and to report long-term value added externally?**
- **How can differences between accounting bases (IFRS, local GAAP, Solvency II) be explained and reconciled? How can comparability during the transition period be achieved?**
- **How will the accounting for financial instruments change?**
- **To what extent do IT-systems, data and processes need to be adjusted to comply with the IFRS requirements? To what extent can these adjustments be anticipated in Solvency II projects? How can Solvency II synergies be leveraged?**
- **What are the impacts of IFRS and US-GAAP divergence?**

Under current International Financial Reporting Standards (IFRS), insurance liabilities are mainly measured in accordance with accounting policies using other accounting regime e.g. local GAAP, US-GAAP or UK-GAAP. Additionally, the policies used in consolidated financial statements are not required to be consistently applied. Consequently, there is no comparability. For the first time, IFRS 4 Phase II will require consistent accounting for insurance contracts. An exposure draft was issued for public comment in June 2013. The final standard is expected to be published in 2015. The effective date of the final standard is expected to be for reporting periods beginning on or after 1 January 2018. Under the exposure draft, the starting point for measuring the insurance liability is the expected future cash flows for fulfiling the contract. The fulfilment of the obligation is based on the entity's perspective (fulfilment value, i.e. no exit value or fair value) and current assumptions are used.

In measuring the insurance liability, the expected future cash flows are discounted to reflect the time value of money. A risk adjustment that reflects the uncertainty about the amount and timing of the cash flows is added to the discounted expected future cash flows. These three 'building-blocks' are remeasured at each reporting date using current information. Another 'building block', the contractual service margin (CSM), is applied to remove any day-one gains. Contrary to what some might expect, fulfilment value is not the same as or may not be largely similar to a market-consistent value, such as the values that a Solvency II Statement of Financial Position is based on.

The CSM represents the unearned profit that the entity will recognize in profit or loss over the coverage period. It will be recognized in a systematic way that best reflects the transfer of services provided under the contract. Profit is recognized over the coverage period because the promise to provide coverage is the relevant service. The claims settlement period is not included. Generally, the allocation of profit over the coverage period is current practice. Different is how the underlying assumptions for the other three building blocks and accounting for changes are treated.

Discounting the expected future cash flows reflects solely the time value of money. Uncertainty about the amount and timing of the cash flows is considered when estimating the expected cash flows and the risk adjustment. Conceptually, the IASB considers the appropriate discount rate to be the rate that is consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract in terms of timing, currency and liquidity. This may be either a risk-free rate adjusted for illiquidity (called the bottom-up approach, generally, this rate is expected to be used for non-life insurance) or a rate based on actual assets or a reference portfolio adjusted to remove the market risk premiums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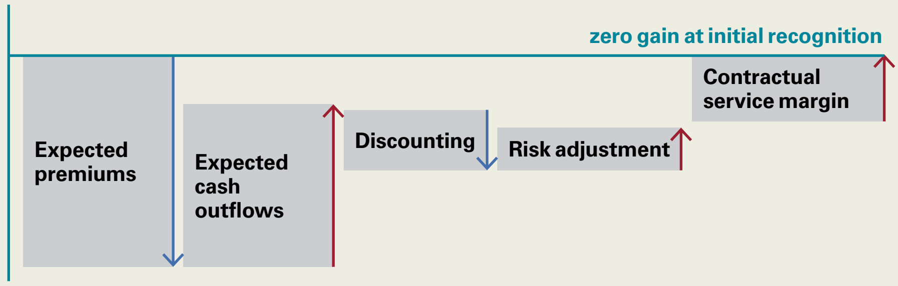
PROPOSED MEASUREMENT MODEL



Source: KPMG International, March 2014

for expected and unexpected losses (called the top-down approach, generally, this rate is expected to be used for life insurance). Under the exposure draft, non-life claims provisions, with certain exceptions, are discounted and profit is recognized earlier than under current accounting, where non-life claims provisions generally are not discounted, unless the risk adjustment exceeds the effect of discounting.

To the extent that the amount, timing or uncertainty of the cash flows arising from the insurance contract depends wholly or partially on returns on underlying items (participating contracts), the discount rate should reflect that dependency. This concept does not apply for the measurement of minimum guarantees. For minimum guarantees, the building-block approach is applied. Under the exposure draft, for certain participating contracts the measurement of the insurance liabilities mirrors the carrying amount of the underlying items. However, the relevant guidance is complex and in some circumstances difficult to apply. It remains to be seen whether the measurement and presentation exceptions for this kind of business will be retained in the final standard.

Due to the long durations of insurance contracts and the resulting effect of leverage, the determination of the discount rate and changes in the discount rate have a major impact on equity and net income. The exposure draft does not prescribe how to determine the discount rate, rather, giving a broad objective as discussed above. Depending on the type of entity and business segment, different discount rates will be applied. The disclosure requirements for discount rates or ranges of discount rates are intended to achieve transparency and market discipline.

Many concerns have been expressed with respect to volatility in profit or loss resulting from short-term interest rate fluctuations which may be inconsistent with the long-term nature of the insurance business. The exposure draft proposed the presentation of changes in insurance liabilities arising from changes in discount rates in other comprehensive income (OCI) as opposed to profit or loss. This achieves a stable presentation in profit or loss, while the financial assets and liabilities in the Statement of Financial Position are measured using current assumptions. Under the exposure draft, changes in the value of minimum guarantees are presented in profit or loss resulting in volatility.

The IASB published an exposure draft of limited amendments to IFRS 9 in November 2012. One of the objectives was to improve the interaction between the accounting for insurance liabilities and for financial assets. This exposure draft proposed that changes in the fair values of some debt instruments should be presented in OCI. However, many investments held by insurers may not meet the criteria for the presentation of changes in the fair values in OCI – e.g. derivatives, structured products or those with participating rights. Accordingly, inconsistencies between the presentation of gains and losses on assets and liabilities may result. The IASB has recently decided to allow insurers an option to present the effects of changes in discount rates for insurance liabilities in profit or loss or OCI in order to reduce accounting mismatches. In addition, the IASB has recently decided that the effective date of IFRS 9 will be 1 January 2018 and it is possible that entities will be able to apply both the new insurance and financial instruments standards at the same time.

For short-term contracts, in particular one-year insurance contracts, the exposure draft permits the application of a simplified approach that is broadly consistent with unearned premiums under current accounting practices for short-term duration contracts.

The exposure draft includes a new presentation of the statement of profit or loss and OCI. Under current accounting practices, premiums are used as a volume measure for revenue and benefits as a volume measure for expenses. These measures are replaced by a presentation that is based on the concepts in the revenue recognition standard that is nearing issuance. The new presentation of premiums and benefits in life and health insurance is significantly different from the current presentation because the timing of recognition differs and all investment components have to be excluded.

For ceded reinsurance, the initial CSM for the reinsurance asset is determined to remove any gain or loss at inception. The reinsurance premiums are reduced by ceding commissions. As a result, for proportional reinsurance the reinsurance asset does not necessarily equal the contractual share in gross insurance liabilities. Profit recognition from the underlying insurance contract and reinsurance contract may diverge if, for example, losses from the underlying insurance contract need to be anticipated in an onerous portfolio.

Impacts of the IASB's proposals:

In the exposure draft, the IASB has addressed many insurers' concerns and brought the publication of an international insurance standard closer to realization. Allowing the presentation of volatility resulting from short-term interest rate fluctuations in OCI may be more consistent with the insurers' long-term business model and makes concessions to analysts who want to project long-term distributable profits. From our perspective, the critical areas within the current proposals and related impacts include:

- The volatility that may be created by certain proposals. For example, volatility in profit or loss and equity may be created due to the use of current assumptions in measuring insurance liabilities or when changes in the values of minimum guarantees due to short-term interest rate fluctuations are presented in profit or loss.
- The interaction between accounting requirements for financial instruments and insurance contracts. The interaction needs to be considered comprehensively to enable users to compare financial results over time. The IASB's recent decision that the mandatory effective date of IFRS 9 will be 1 January 2018, incentivizes the IASB to progress expeditiously on the insurance contracts project with a view to having aligned effective dates.
- Concerns about the presentation of the statement of profit or loss and OCI, including the new proposed measure of volume and new definition of the term 'revenue' for insurance contracts. These proposals could result in a major change in practice. The IASB needs to consider whether the presentation proposals, including the different presentations of the effects of changes in profit or loss, OCI or CSM, will provide the information that users consider most relevant.
  In any case, complexity for insurers – and users – will increase and represent an operational challenge.

- Contracts with participating features. The current proposals are complex, and difficult both to understand and to apply consistently. The final standard should include a clearly defined, overall principle in accounting for contracts with participating features.

FASB CHANGES DIRECTION AND SCOPE OF INSURANCE PROJECT

The FASB recently decided to change the future direction of the insurance contracts project and to limit the scope to insurance entities. However, the Board said that contracts written by non-insurers may be added back as the project progresses.

Key Facts

- The Board made decisions on the direction of the project. Specifically, the Board decided:
  - For short-duration contracts, to focus its efforts on targeted improvements to disclosures, without changing the current US-GAAP model for recognition and measurement.
  - For long-duration contracts, to work on targeted improvements to current US-GAAP and then evaluate how those improvements compare to the building-block approach as determined by the IASB.
  - The FASB decided to limit the scope of the project to insurance entities, which is consistent with current US-GAAP, and to not extend it to other entities that issue insurance contracts (although some non-insurers may be added back later).

Key Impacts

- The decision reached on the future direction of the project is likely to lead to further non-convergence with the IASB.
- The decision reached on scope will limit which companies would fall under the scope of the insurance contracts project. Previously all companies that issued insurance contracts (e.g., product warranties issued by third parties, some financial guarantees, and surety bonds) would have been in the scope of the proposed insurance standard.

Abbreviations

APRA	Australian Prudential Regulation Authority
BCR	Basic Capital Requirement
BCR	Backstop Capital Requirements
BION	Badanie i Ocena Nadzorcza – Supervisory Review and Assessment
BMA	Bermuda Monetary Authority
BNM	Bank Negara Malaysia
CAR	Capital Adequacy Ratio
CBB	Central Bank of Bahrain
CEE	Central and Eastern Europe
CIF	Coordinated Implementation Framework
CIRC	China Insurance Regulatory Commission
CMA	Capital Market Authority
CNSF	Insurance and Surety National Commission
ComFrame	Common Framework for the Supervision of Insurance Groups
CRA	Credit Rating Agencies
CRO	Chief Risk Officer
C-ROSS	China Risk Oriented Solvency System
D-SIIs	Domestic Systemically Important Insurers
EIOPA	European Insurance and Occupational Pensions Authority
EOF	Eligible Own Funds
ERM	Enterprise Risk Management
ESRB	European Systemic Risk Board
FASB	Financial Accounting Standards Board
FATF	Financial Action Task Force
FCR	Financial Condition Report
FinCoNet	The International Financial Consumer Protection Organization
FIO	Federal Insurance Office
FLAOR	Forward Looking Assessment of Own Risks
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSOC	Federal Stability Oversight Council
FTTF	Field Testing Task Force
GAAP	Generally Accepted Accounting Principles
G-SIIs	Global Systemically Important Insurers
HLA	Higher Loss Absorption
HPS	Health Protection Scheme
IAIGs	Internationally Active Insurance Groups
IAIS	International Association of Insurance Supervisors
IBRF	Islamic Banking Regulatory Framework
ICAAP	Internal Capital Adequacy Assessment Process
ICM	Internal Capital Models
IASB	International Accounting Standards Board
ICPs	Insurance Core Principles
ICS	Insurance Capital Standard
FSA	Financial Services Act
IFSA	Islamic Financial Services Act
IIA	Independent Insurance Authority
ILAB	Insurance Laws Amendment Bill
IMD	Insurance Mediation Directive
IMF	International Monetary Fund
IRDA	Insurance Regulatory and Development Authority
KID	Key Information Document
LAGIC	Life and General Insurance Capital
LIRF	Life Insurance Regulatory Framework
MAS	Monetary Authority of Singapore
MPS	Macroprudential Policy and Surveillance
NAIC	National Association of Insurance Commissioners
NARAB	National Association of Registered Agents and Brokers Reform Act
NCA	National Competent Authority
NRRA	The Nonadmitted and Reinsurance Reform Act
NTNI	Non-Traditional Non-Insurance
OCI	Office of the Commissioner of Insurance
OCI	Other Comprehensive Income
OECD	Organization for Economic Co-operation and Development
OJK	Otoritas Jasa Keuangan – Financial Services Authority of Indonesia
ORSA	Own Risk and Solvency Assessment
OSFI	Office of the Superintendent of Financial Institutions
PBR	Principles-Based Reserving
PCR	Prescribed Capital Requirement
PHIAC	Private Health Insurance Administration Council
PINS	Prudential Insurance Rulebook
PRA	Prudential Regulation Authority
PRIPs	Packaged Retail Investment Products
QCB	Qatar Central Bank
QFC	Qatar Financial Centre
QFCRA	Qatar Financial Centre Regulatory Authority
QISs	Quantitative Impact Studies
RBC	Risk-Based Capital
RRP	Recovery and Resolution Planning
SAM	Solvency Assessment and Management
SAMA	Saudi Arabia Monetary Authority
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
SMI	Solvency Modernization Initiative
SVS	Superintendencia de Valores y Seguros
ULIP	Unit Linked Insurance Plan

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