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International developments dominate regulatory change

Evolving Insurance Risk and Regulation
Preparing for the future: Chapter 1

June 2016

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International developments dominate regulatory changes

As we reported in last year's *Evolving Insurance Regulation* publication, 2015 saw the International Association of Insurance Supervisors (IAIS) continue developing its work in relation to Internationally Active Insurance Groups (IAIGs) and Global Systemically Important Insurers (G-SIIs), with group-wide supervision and consistency of regulatory frameworks across geographical jurisdictions remaining significant themes driving regulatory reform. The Financial Stability Board (FSB) continues to influence the IAIS work program and it is clear that 2016 will be another pivotal year.

In this chapter, we also discuss the impact these key initiatives may have on insurers, especially in relation to the Insurance Core Principles (ICPs), the global Insurance Capital Standard (ICS), and G-SII specific developments. We also consider the latest update on the International Monetary Fund (IMF)'s Financial Sector Assessment Program (FSAP) reviews.

Table of contents

Evolving Insurance Risk and Regulation is an annual report published by KPMG International covering the key regulatory topics facing the Insurance industry. This report is in its sixth year of publication, and this year you will note, it is evolving to better reflect what is happening in the market, notably, adding "risk" to the title. Another change to this year's report is that it will be published as a series of chapters with the first chapter launching alongside the IAIS event in June, and concluding with KPMG International's first ever Risk and Regulatory benchmark survey to correspond with the IAIS meeting in Paraguay in November.

This chapter, "International developments dominate regulatory change," is the first in the series, and sets the tone for the major regulatory themes happening globally. The insights are based on discussion with KPMG member firms' clients, KPMG professionals' assessment of key regulatory developments and through KPMG links with policy bodies in each region. The second chapter, "Conduct risk —Increasing regulatory focus to align product, customer" offers insights on industry developments by region with commentary on how regulators are driving change to align products and customers. Additional chapters and analysis will be published monthly with the final instalment of the results of our Benchmark survey that will be presented in Paraguay. Visit www.kpmg.com/regulatorychallenges for more information, or reach out to fsregulation@kpmg.co.uk.

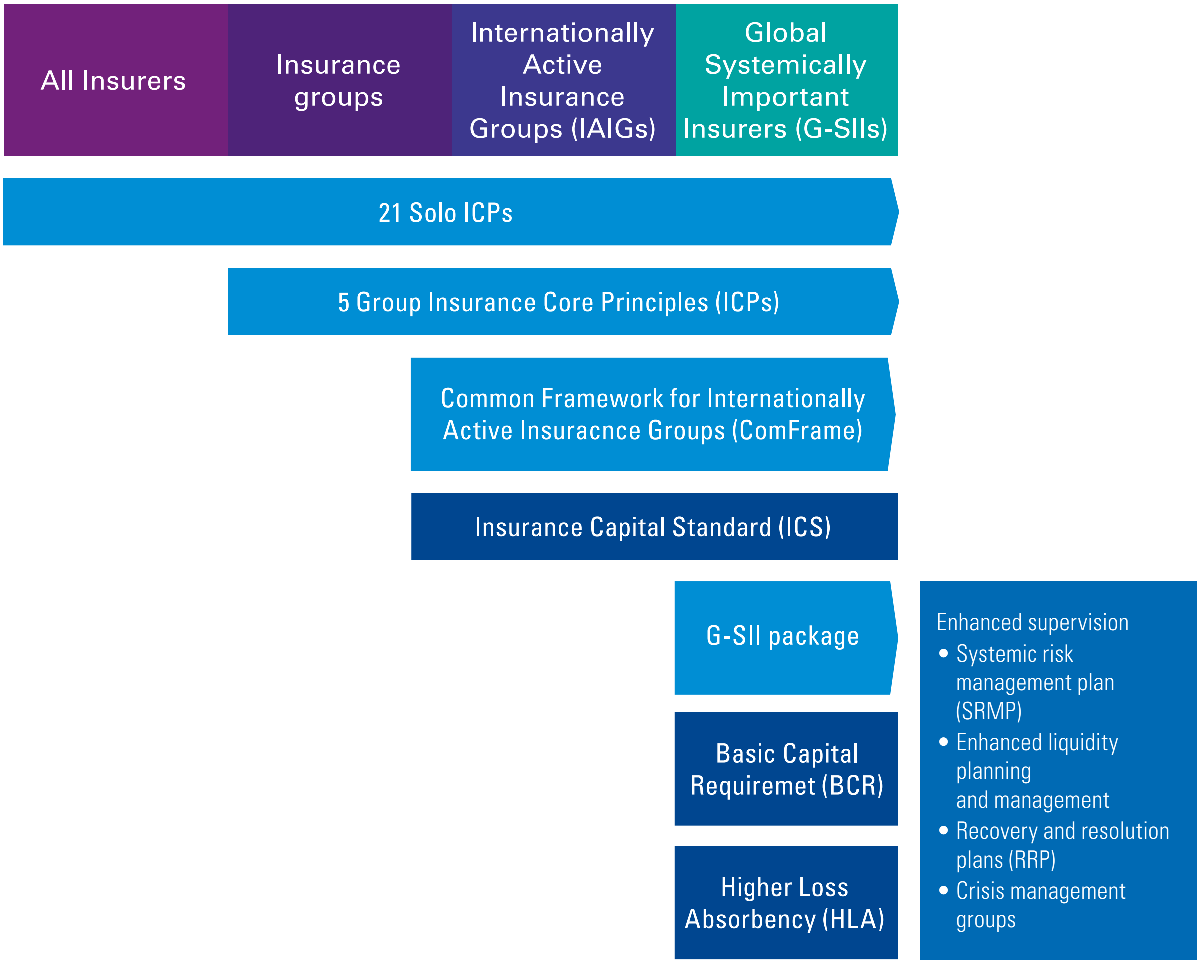
IAIS Framework

The IAIS Framework is a globally accepted framework for the supervision of the insurance sector. The material is structured in a series of increasing regulatory requirements depending on the nature of the entity being supervised:

- The Insurance Core Principles (ICPs) are high-level principles-based standards that are to be followed for the supervision of insurers in all jurisdictions. These mainly apply to regulated insurance entities, but are supplemented by five group ICPs that apply to the wider insurance group.
- The Common Framework for IAIGs (ComFrame) applies further requirements against the approximately 50 insurance groups that meet the IAIG definition. This population of firms will need to comply with the insurance capital standard that the IAIS is developing.
- The G-SII population (nine groups currently) must comply with all of the above requirements and are subject to enhanced supervision due to their perceived systemic risk. This includes both additional capital requirements and recovery and resolution planning measures.

The hierarchy of application of the requirements can be demonstrated as shown in Figure 1.

Figure 1: Application of the IAIS Framework to different types of insurers/insurance groups



Source: KPMG International 2016.

"The Insurance Core Principles (ICPs) are high-level principles-based standards that are to be followed for the supervision of insurers in all jurisdictions. "

Insurance Core Principles (ICPs)

IAIS Members are expected to implement the ICPs into their national supervisory frameworks. Compliance is assessed by the IMF and World Bank who conduct annual Financial Sector Assessment Programme (FSAP) reviews on both a mandatory and voluntary basis. Mandatory FSAP assessments are required every five years for countries whose financial systems have been deemed by the IMF to be systemically important (see Table 1).

There are currently 26 ICPs that can be divided into broad categories as set out in Table 1:

"Compliance is assessed by the IMF and World Bank who conduct annual Financial Sector Assessment Programme (FSAP) reviews on both a mandatory and voluntary basis"

Table 1: Five categories of the ICPs

Supervisory Powers and Measures	Solvency	Group Supervision, Cooperation and Crisis Management	Conduct of Business, Intermediaries and Fraud Prevention	Corporate Governance and Public Disclosure
ICP 1 Objectives, powers and responsibilities of the supervisor	ICP 13 Reinsurance and other forms of risk transfer	ICP 3 Information exchange and confidentiality requirements	ICP 18 Intermediaries	ICP 5 Suitability of persons
ICP 2 Supervisor	ICP 14 Valuation	ICP 23 Group-wide supervision	ICP 19 Conduct of business	ICP 7 Corporate governance
ICP 4 Licensing	ICP 15 Investment	ICP 24 Macroprudential surveillance and insurance supervision	ICP 21 Countering fraud in insurance	ICP 8 Risk management and internal controls
ICP 6 Changes in control and portfolio transfers	ICP 16 Enterprise risk management for solvency purposes	ICP 25 Supervisory cooperation and coordination	ICP 22 Anti-Money laundering and combating the financing of terrorism	ICP 20 Public disclosure
ICP 9 Supervisory review and report-ing	ICP 17 Capital adequacy	ICP 26 Cross-border cooperation and coordination on crisis management		
ICP 10 Preventive and Corrective Measures				
ICP 11 Enforcement				
ICP 12 Winding-up				

Source: Insurance Core Principles Standards Guidance and Assessment Methodology, October 2011 revised October 2013.

The IAIS began a three year review of all ICPs in 2015, starting with a self-assessment and peer review of ICP 4 (Licensing), ICP 5 (Suitability of Persons), ICP 7 (Corporate Governance), ICP 8 (Risk Management and Internal Controls), ICP 23 (Group-wide Supervision) and ICP 25 (Supervisory Cooperation and Coordination). In November 2015, it adopted revisions to each of these ICPs.

In January 2016, it began the self-assessment and peer review of ICP 13 (Reinsurance and Other Forms of Risk Transfer) and ICP 24 (Macroprudential Surveillance and Insurance Supervision).

The IAIS also announced in January 2016 that it plans to issue a consultation document in mid 2016 proposing the application of recovery and resolution planning requirements applicable to all insurers. To date, only the nine G-SIIs have been subject to such requirements and the announcement of this extention has surprised many, with significant concerns regarding how this will be constructed to ensure it is proportionate to the rest of the insurance sector. We await this paper with interest.

Financial Sector Assessment Program (FSAP) reviews

These reviews include an analysis of the extent of compliance with relevant international standards, which for the insurance sector means an assessment of compliance with ICPs. The result has been a global drive among regulators over recent years to demonstrate ICP compliance, as demonstrated in Chapter 3 covering country developments.

The most recent FSAP review for those countries whose financial systems have been deemed by the IMF to be systemically important is set out in Table 2 below. Finland and Norway were added to the list in January 2014 and have not yet been subject to a mandatory review. Assessments of countries shown in dark blue were based on the revised 2011 ICPs.

Table 2: Systemically important financial countries and year of assessment

Australia (2012)	Denmark (2014)	Ireland (2015)	Netherlands (2011)	Sweden (2011)
Austria (2013)	Finland (2001)	Italy (2013)	Norway (2005)	Switzerland (2014)
Belgium (2013)	France (2012)	Japan (2012)	Poland (2013)	Turkey (2011)
Brazil (2012)	Germany (2011)	Korea (2014)	Russian Federation (2011 – no grading)	United Kingdom (2011)
Canada (2014)	Hong Kong SAR (2014)	Luxembourg (2011)	Singapore (2013)	United States (2015)
China (2011)	India (2012)	Mexico (2012)	Spain (2012)	

Sources: 1) country list from IMF website (http://www.imf.org/external/np/fsap/mandatoryfsap.htm);
2) dates from reports on IMF website (http://www.imf.org/external/np/fsap/fssa.aspx).

"A consistent area of perceived weakness relates to ICP 2 (Supervisor), including independence and staff recruitment and retention."

2015 saw the release of the Detailed Assessment of Observance on ICP's Compliance reports on South Africa (March), United States (April) and Ireland (May) (see Table 3, page 6). The results for Ireland reflect the regulatory regime in force at the time of the assessment and therefore do not reflect the revisions to the regime resulting from the introduction of Solvency II within Europe from 1 January 2016.

Taking these three reports with the four issued in 2014 (Switzerland, Canada, Hong Kong and Denmark), a consistent area of perceived weakness relates to ICP 2 (Supervisor) where six of the seven countries scored only partial observation. Areas of concern raised included independence and challenges around staff recruitment and retention. For ICP 23 (Group-wide Supervision), five countries were graded partial observation, although most of these regimes are evolving in this area. In addition, all four of the 2014 reviews also reported only partial observation in relation to ICP 19 (Conduct of Business), which is not reflected in the 2015 results shown in Table 3. The 2016 FSAP review program was announced in January 2016[1]. This will include a focus of systemic risks and macroprudential policies. Highlights are expected to be the reviews of China, Germany, Ireland, Russia, Sweden, Turkey and the United Kingdom.

[1] http://www.imf.org/external/pubs/ft/survey/so/2016/pol011416a.html

Table 3: KPMG overview of 2015 FSAP results

ICP/country	South Africa	United States	Ireland
Supervisory powers and measures			
1 Powers	2	1	3
2 Supervisor	1	1	1
4 Licensing	2	2	3
6 Control	2	3	3
9 Reporting	2	2	1
10 Correction	3	3	2
11 Enforcement	3	3	3
12 Winding Up	1	3	3
Solvency			
13 Reinsurance	2	3	2
14 Valuation	2	1	2
15 Investment	2	3	2
16 ERM	1	2	2
17 Capital Adequacy	2	2	1
Group supervision, cooperation and crisis management			
3 Info exchange	3	2	3
23 Groups	1	1	1
24 Macroprudential	2	2	3
25 Coordination	3	2	3
26 Crossborder	2	2	2
Conduct of business, intermediaries, and fraud prevention			
18 Intermediaries	3	2	3
19 Conduct of business	2	2	2
21 Anti-fraud	1	3	3
22 AML	1	2	2
Corporate governance and public disclosure			
5 Suitability	3	2	2
7 Corporate governance	1	1	2
8 Risk management	1	2	3
20 Disclosure	1	3	1
Total	49	55	58

3 Observed 2 Largely Observed 1 Partially Observed

Source: KPMG 2016.

Common Framework for IAIGs (ComFrame)

Development of ComFrame began in 2009. There is an on-going program of field testing, which started in 2014 and will continue through to its planned approval at the end of 2019. Current plans are for implementation in early 2020, although an earlier version of the Insurance Capital Standard (ICS) will be finalized by mid-2017 to be used for private reporting to the group supervisors from 2017.

While the ICPs apply to the supervision of all insurance entities, ComFrame is only applicable to those insurance groups identified as an Internationally Active Insurance Group (IAIG) by its national supervisor. The IAIS has indicated that there are approximately 50 global insurance groups classified as IAIGs, although no lists are published.

An IAIG must meet the following broad criteria:

- At least one large insurance entity in the group
- International activity: premiums written in at least three jurisdictions with at least 10% of the group's gross written premium (GWP) being from outside the home jurisdiction.
- Size of insurance activity: broadly GWP of not less than US$ 10 Billion or total assets not less than US$ 50 Billion, based on a rolling three-year average.

Due to their perceived complexity, this additional framework will facilitate group supervision, ensuring that group-wide risks are appropriately assessed and regulatory gaps are avoided. ComFrame will enable supervisory cooperation and coordination and effective information sharing between supervisors, with the group-wide supervisor responsible for the supervision of the IAIG as a whole on a group-wide basis. The group-wide supervisor will be able to exercise some "direct" powers at the level of the head of the insurance group, including:

Information requests, including related to subsidiaries relevant to the overall risk of the IAIG

- On-site inspections
- Formal discussions with members of the governing body, senior management and key persons in control functions of the head of the insurance group
- Fit and proper assessments of these individuals

> "The IAIS has indicated that there are approximately 50 global insurance groups classified as IAIGs, although no lists are published."

Although much focus has been given to the development of appropriate group capital standards, ComFrame is much wider than this, including both quantitative and qualitative elements, as shown below:

Figure 2: ComFrame modules

Module 1: Scope of ComFrame	
Elements 1 & 2	IAIG definition and identification process
Element 3	Scope of ComFrame supervision and process to determine entities to be covered

Module 2: Elements of IAIG Compliance	
Element 1	Legal and management structures, cross-border issues and complexities
Element 2	Group-wide governance framework, including roles of the Governing Body and Senior Management of the Head of the IAIG, Senior Management and Key Control Functions
Element 3	Enterprise Risk Management (ERM) requirements
Element 4	Group-wide ERM policies required, including investment, underwriting, claims management, reinsurance strategy, insurance liability valuation and actuarial
Element 5	Insurance Capital Standard (ICS)

Module 3: Supervisory requirements	
Element 1	Group-wide supervisory process
Element 2	Supervisory cooperation and interaction, including requirement for supervisory colleges
Element 3	Crisis management and resolution

Module 2 Element 5 (Insurance Capital Standard) and Module 3 Element 3 (Crisis management and resolution) are not included in the draft of ComFrame currently available, as work in these areas is ongoing. These elements are discussed on the following pages.

Global Insurance Capital Standard

The IAIS released a set of high level principles in September 2014 to be used to guide the development of the global ICS. These were consulted on in December 2014, with only minor revisions made in 2015 following feedback received.

The IAIS consultation document[1] on its first draft proposal of the ICS in December 2014 generated over 1500 pages of comments. The IAIS has provided its feedback on a piecemeal basis, with updates in June[2], October[3] and November 2015[4] on key components. While some decisions have been taken, it is evident that further refinement will be made, dependent on the results of current and future field testing.

For ICS purposes all G-SIIs are considered to be IAIGs.

Timeline and process

The IAIS has reconfirmed its aim of convergence in global regulatory capital frameworks over time, recognizing the challenges associated with a project of this nature. An ICS Version 1.0 will be released in time for private reporting to supervisors from 2017. However, the version that will be used for public reporting (ICS Version 2.0) will not be adopted until the 2019 IAIS Annual General Meeting. The next public consultation document on the ICS is expected in June 2016.

The IAIS also recognizes the need for an implementation period after adoption, to enable jurisdictions to embed the ICS into local requirements. Further, the IAIS recognizes that some form of transitional measures and phasing-in for certain elements of the ICS may be necessary in some jurisdictions.

Interaction between ICS and existing frameworks

The IAIS has said little to date regarding any form of jurisdiction recognition process (such as Solvency II's equivalence assessment process) to help supervisory authorities and insurance groups manage potential conflicts between the ICS and any local group solvency calculation requirements. This will be important for groups, as the challenges of managing different group metrics could be significant, especially if they react differently to proposed mitigating actions. Non-recognition of local group requirements could also introduce competition issues within a jurisdiction between the IAIGs to whom the ICS applies and other insurance groups.

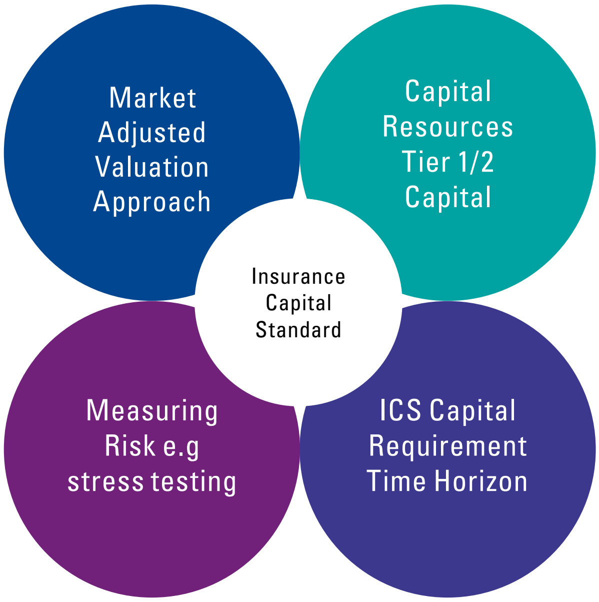
This is a difficult matter to resolve, as the global ICS is intended to enhance comparability across the IAIG population over time, achieving comparable (which has been confirmed means 'substantially the same') outcomes across jurisdictions. Nevertheless, we believe a jurisdiction recognition process will need to be included in the final ICS (Version 2.0).

Recognising that comparability of outcomes will only be achieved over time, the current focus will remain on developing the standard method approach. Variations to this, including the possibility of recognition of internal models will be dealt with later in the development process. In this regard, we note that a partial internal model for catastrophe risk was allowed within the 2015 field test.

Key components of ICS

The key components of the ICS remain valuation methodology, qualifying capital resources, risk measurement and capital requirements, as illustrated in Figure 3 below. We provide below an update on the key developments since the release of the consultation paper. Reference can also be made to the 2015 edition of *Evolving Insurance Regulation* for our detailed commentary on the original proposal.

Figure 3: Four key elements of the Insurance Capital Standard Results



Source: KPMG International 2016.

[1] IAIS Consultation Paper: Risk-based Global Insurance Standards, 17 December 2014
[2] ICS Consultation Document — Responses to stakeholder comments on selected questions published on 18 June 2015
[3] ICS Consultation Document — Responses to Selected Comments published on 5 October 2015
[4] ICS Consultation Document — Responses to Comments: ICS Valuation Methods (Section 5) and Responses to Comments on Capital Resources (Section 6) published on 20 November 2015

Valuation approach

A key issue in the development of a global liability valuation approach for the ICS has been the lack of a global insurance accounting standard for insurance contracts. Work on the insurance contract accounting standard (IFRS 4) has continued in parallel, however the final standard is not expected to be issued until around the end of 2016 with an effective date unlikely to be before 1 January 2020. This has therefore necessitated development of a stand-alone ICS valuation methodology, designed to broadly reflect the insurance liability valuation requirements of IFRS 4. This basis is known as the market-adjusted valuation basis, however the IAIS has indicated that further refinement to this basis is likely to be needed for the 2016 field testing exercise.

An alternative approach based on Generally Accepted Accounting Principles with adjustments (known as GAAP+) is being assessed. This has mainly been driven by the United States, with the intention of allowingIAIGs to achieve a quasi-market adjusted valuation by applying adjustments to their local jurisdictional GAAP figures.

The IAIS has confirmed that the version of the ICS that will apply from 2017 (ICS Version 1.0) will permit both valuation approaches, although it has not yet reached a decision regarding ICS Version 2.0. While recognizing that the required adjustments will depend on the underlying GAAP adopted, the IAIS has developed a set of principles aimed at encouraging comparability across jurisdictions.

One of the key areas for discussion in relation to the valuation of insurance liabilities relates to whether a margin over current estimate (MOCE) should be required. The inclusion of a MOCE within the valuation of insurance contract liabilities would effectively result in the deferral of profit emergence.

The consultation document included questions regarding its purpose (additional prudence or to reflect the cost of transferring the insurance portfolio), treatment (i.e. as an additional component of insurance liabilities in addition to the current estimate or as part of capital resources) and calculation basis. There were mixed responses to these questions, especially regarding its purpose, and the IAIS has confirmed that more work will be required on the MOCE in order to achieve comparability. It has confirmed that the MOCE will also be relevant where the GAAP+ approach is followed, citing ICP 14.7 which requires that the valuation of insurance liabilities should include a MOCE.

Another unresolved issue relates to the definition of insurance contract boundaries. The 2015 field testing exercise included a number of questions that explored issues with the current definition.

On discount rates, the IAIS has recognized the need to refine the IAIS yield curve methodology. The new methodology is based on a three segment discount curve. The first segment is based on liquid market information, the second segment is based on extrapolating this up to 60 years maturity and the third segment involves using a long-term forward rate for longer durations. The IAIS has also confirmed that it expects to develop a fixed methodology rather than simply establishing principles to create the yield curve.

Qualifying capital resources

As the ICS capital requirement will be a regulatory Prescribed Capital Requirement (PCR)[5], all IAIGs will need to hold qualifying capital resources that are at least equal to their ICS capital requirement. In the consultation document, the IAIS proposed four broad categories of capital resources as follows:

- Tier 1 financial instruments for which there is no limit (for example, common/ordinary share capital).
- Tier 1 financial instruments for which there is a limit (for example, non-cumulative perpetual preferred shares and certain hybrid instruments).
- Paid-Up Tier 2 financial instruments (for example, subordinated debt).
- Non-Paid-Up Tier 2 financial instruments (only with supervisory approval and subject to being capable of conversion into an instrument falling within one of the other categories).

The IAIS has confirmed the general distinction between those elements that absorb losses on a going concern and winding-up basis (Tier 1) and those that only absorb losses in a winding-up situation (Tier 2). In particular, following the guidance in ICP 17.11, the IAIS will continue to assess capital resources based on their loss absorbency capacity, considering the capital instrument’s subordination, availability, permanence and absence of encumbrances and mandatory servicing cost features. However, the IAIS also confirmed that it will consider the appropriateness of a principal loss absorbency mechanism for ‘Tier 1 instruments for which there is a limit’.

As a group capital standard, the issue of fungibility of capital remains an important consideration. However, the IAIS has confirmed that cross-sectoral aspects will be dealt with by determining capital resources at a consolidated level (but not capital requirements which will be aggregated by sector).

The proposed deductions from Tier 1 and Tier 2 capital (including intangible assets, goodwill, net deferred tax assets and investment in own assets) will be retained, but the list could be extended depending on the results of the 2016 field testing exercise, which will also test the proposed capital composition limits. Finally, the IAIS has stated that it will consider which types of non-controlling interests can be included in capital resources and how the qualifying amount should be determined.

[5] In the IAIS’ core principles, the PCR is the higher regulatory intervention point, while a Minimum Capital Requirement (MCR) serves as the lower intervention level.

Risk Measurement Approaches

No changes have been proposed to the list of risks that will be included in the ICS (insurance, market, credit and operational risks), although the IAIS will consider further how to quantify operational risk within the capital requirement. It has also clarified that catastrophe risk is relevant for both life and non-life insurance and will remain a separate component within insurance risks. For asset concentration risks, the IAIS proposes to use the results from the 2015 field testing exercise to assess further whether or not this is required as a module within market risk and if so the basis to be applied.

No update has been provided regarding the various approaches for determining the ICS capital requirement by risk measure, so the presumption is that the proposed approach outlined in the consultation document (applying a factor based approach, stress testing, stochastic modelling and structural modelling or a combination dependent on the nature of the risk) will continue to apply. Similarly, there has been no update regarding the allowance for diversification.

ICS Capital Requirement

Despite opposition from stakeholders, the IAIS has confirmed that the ICS capital requirement will be a regulatory Prescribed Capital Requirement (PCR), meaning that the supervisor will only intervene on capital adequacy grounds if the group's capital resources falls below the group capital requirement. However, no decision has yet been taken regarding the inclusion of a backstop capital measure, and the IAIS has indicated that this will not be revisited until ICS Version 1.0 is complete.

In relation to the cross-sectoral aspects of the ICS, the IAIS has confirmed that the capital requirements across sectors will be aggregated (in contrast to the capital resources which will be determined at a consolidated level).

Importantly, the IAIS has resolved the question of the forward looking time frame for capital purposes, proceeding with the one-year time horizon, assuming that the IAIG will carry on existing business as a going concern.

Regulation of Global Systemically Important Insurers (G-SIIs)

Most G-SIIs will meet the definition of an IAIG and therefore be subject to the requirements of ComFrame. Irrespective of this, the IAIS has also confirmed that all G-SIIs will be considered to be IAIGs for ICS purposes and therefore need to comply with this group-wide capital standard. However, G-SIIs are also subject to the enhanced supervisory requirements in the G-SII package of IAIS requirements. This includes:

- Enhanced group supervision, giving the group supervisor direct powers over holding companies and oversight of the group systemic risk management plan (SRMP) and liquidity management plan
- An additional capital requirement (the higher loss absorbency (HLA)) and
- Group-wide resolution planning and resolvability assessments and the establishment of crisis management groups (CMGs).

There have been a number of developments in 2015, which are discussed below.

G-SII population

The November 2015 announcement by the FSB saw the first change in the list of identified G-SIIs since 2013. Generali was removed from the list and Aegon was added to it. This confirms that it is possible for a G-SII to exit the classification, although it should be noted that the proposed assessment methodology (covered below) proposes that the classification should be in force for a minimum of two years from an insurance group's first assessment as a G-SII.

The current population of G-SIIs is now as follows:

Table 4: 2015 List of identified G-SIIs

Aegon N.V.	Aviva plc	Ping An Insurance (Group) Company of China, Ltd.
Allianz SE	Axa S.A.	Prudential Financial, Inc.
American International Group, Inc.	MetLife, Inc.	Prudential plc

Source: FSB 2015 Update of List of Global Systemically Important Insurers, 3 November 2015

The resolvability assessment process will be conducted in 2016 for all firms except Aegon, for whom this will be in 2017.

G-SII Assessment Methodology

In November 2015, the IAIS released a consultation document[6] proposing various refinements to the G-SII Assessment Methodology that was originally finalized in 2013. This aims to increase transparency about the assessment process and provide greater data quality assurance to enable more informed decision-making. The intention is for the revised approach to be applied from the 2016 assessment process.

Key changes include the introduction of a five phase approach (that includes a qualitative assessment phase to complement the previous quantitative-only approach), refinements to some indicators to improve their risk sensitivity and introduction of a reinsurance supplemental assessment.

The proposed five phase approach comprises.

- Phase I: Data Collection from approximately 50 insurance groups in the assessment pool[7]
- Phase II A: Quality Control and Scoring, including data verification and ranking based on the quantitative calculation
- Phase II B: Determination of Quantitative Threshold, which will divide insurance groups into potential G-SII (and subject to the subsequent phases) and non G-SII
- Phases III to V only apply in relation to the potential G-SIIs identified at the end of phase II
- Phase III: Discovery phase, where additional information, both qualitative and quantitative considerations, will be taken into account
- Phase IV: Exchange with prospective G-SIIs, allowing the relevant insurance groups the opportunity to present other information that may be relevant to the assessment of their G-SII status
- Phase V: IAIS Recommendation to the FSB.

In terms of the quantitative component of the methodology, the IAIS has proposed the introduction of a small number of absolute reference values (specifically for derivatives trading (CDS protection sold), financial guarantees and reinsurance categories). The score for these indicators would no longer be calculated solely based on the relative importance of the potential G-SII compared to its peers in the assessment pool, but will also take into account market developments. The intention is to enable changes in the systemic risk of these areas to be assessed over time and ensure that the methodology is responsive to changes in the insurance industry's

Table 5: Proposed weights given to each category and individual indicators

Category	Category weighting	Individual indicator	Indicator weighting
Size	5%	Total assets	2.5%
		Total revenues	2.5%
Global activity	5%	Revenues derived outside of home country	2.5%
		Number of countries	2.5%
Interconnected-ness	40%	Intra-financial assets	6.7%
		Intra-financial liabilities	6.7%
		Reinsurance*	6.7%
		Derivatives	6.7%
		Turnover	6.7%
		Level 3 assets	6.7%
Non-traditional insurance and non-insurance activities	45%	Non-policyholder liabilities and non-insurance revenues	7.5%
		Derivatives trading*	7.5%
		Short term funding	7.5%
		Financial guarantees*	7.5%
		Minimum guarantee on variable insurance products	7.5%
		Liability liquidity	7.5%
Substitutability	5%	Premiums for specific business lines	5%

* The IAIS proposes to use absolute reference values for these indicators

Source: IAIS Consultation Document — Global Systemically Important Insurers: Proposed Updated Assessment Methodology, 25 November 2015 systemic profile as a whole. However, it is unclear how responsive the G-SII assessment score will be to changes in the underlying systemic risk profile of the insurance sector.

For the quantitative calculation, the category weightings remain unchanged, with equal weighting given to the components within those categories. However, the IAIS has proposed to remove three indicators (large exposures, intra-group commitments and derivatives trading (excluding hedging and replication) in economic terms) out of phase II and into phase III, which changes some of the individual indicator weightings in affected categories. The proposed weightings are set out in Table 5 below.

In addition, a reinsurance supplemental assessment will be introduced for groups with significant third-party reinsurance activities that are above the phase II threshold. The additional information requested, including top 10 assumed exposures from ceding insurers and top 5 exposures to other reinsurers, will help the IAIS assess whether a group's third-party reinsurance activities could present a systemic risk to large, interconnected primary insurers and the global financial system.

Although the IAIS proposes that the assessment scores will be set at the end of phase II (other than to correct for data errors), the final recommendations at phase V will be determined based on all of the previous phases.

Non-Traditional Non-Insurance (NTNI) activities

In November 2015, the IAIS released a consultation document[8] proposing an objective framework for identifying non-traditional insurance activities conducted by an insurance group. The non-traditional (NT) insurance classification has been a key concern amongst insurance groups since the introduction of the NTNI concept in 2013, with many arguing that insurance does not generate systemic risk per se. In this document, the IAIS changes the focus from a simple consideration of insurance products to a discussion about the various features within insurance products that could potentially have systemic risk implications.

This is a critically important aspect for G-SIIs and potential G-SIIs, due to the role it plays in both the identification of G-SIIs (where 45% of the assessment criteria relates to NTNI activities — see section above) and the determination of the basic capital requirement (BCR) and higher loss absorbency (HLA) requirement (see section below). However, the paper is unclear regarding who will be responsible for the designation of insurance activities as NT. We believe this should fall to the group supervisor, with input from other relevant supervisors, and in consultation with the insurance group.

The paper represents the first of a three-step process to clarify the NTNI concept, with the IAIS aiming to finalise all three steps in time to be included within the 2016 G-SII designation exercise. These steps are:

- Step 1: Finalise the analytical framework based on product features (as proposed in the consultation paper)
- Step 2: Assess and classify the list of products and activities identified against the framework of product features
- Step 3: Identify any gaps in, or necessary modifications to, the framework and existing principles.

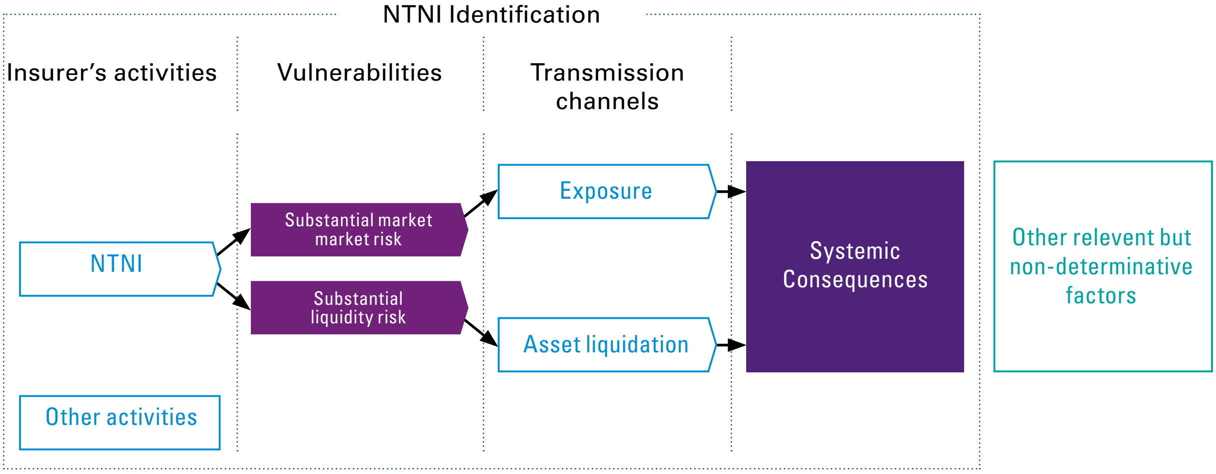
In determining what is potentially systemic, the IAIS has proposed a three step approach, as explained by Figure 4. This involves.

- Analysing product features of insurance contracts to identify potential vulnerabilities that could be created, considering both whether this could involve substantial market or liquidity risk.
- Determining how these features could lead to systemic outcomes (for example could this exacerbate shocks within the financial markets through exposure to counterparties or could an insurer's need for liquidity create asset price volatility through forced asset sales?).
- Considering whether there are any exacerbating factors that need to be taken into account which are relevant to systemic risk outcomes.

[6] IAIS Consultation Document — Global Systemically Important Insurers: Proposed Updated Assessment Methodology, published on 25 November 2015
[7] The criteria for insurers to be included in the data collection phase are:
- total assets of more than US$ 60 billion and a ratio of premiums from jurisdictions outside the home jurisdiction to total premiums of 5% or more and
- total assets of more than US$ 200 billion and a ratio of premiums from jurisdictions outside the home jurisdiction to total premiums between 0% and 5%.

[8] IAIS Consultation Document: Non-traditional Non-insurance Activities and Products, published 25 November 2015

Figure 4: NTNI Identification process



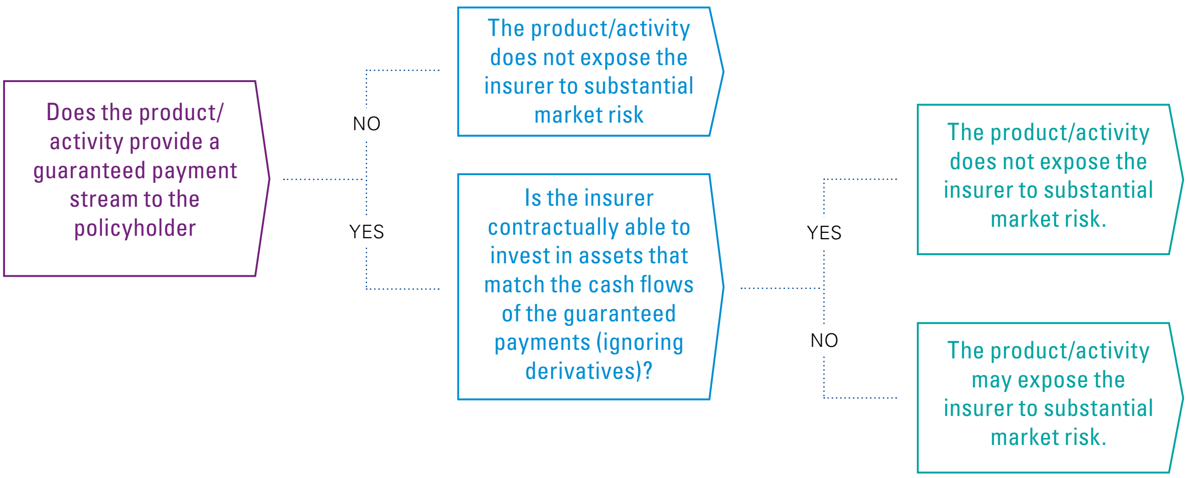
Source: IAIS Consultation Document — Non-traditional Non-insurance Activities and Products, 25 November 2015

The IAIS has concluded that it is the presence of guarantees within insurance contracts which could give rise to substantial market risk and any options that allow for withdrawal (such as surrender clauses) that could give rise to substantial liquidity risk.

For the assessment of substantial market risk, the IAIS proposes the following framework (Figure 5) be applied to products based on their features. The existence of a guarantee and the extent to which an insurer can invest in assets to match the cash flows of the guaranteed payments are critical considerations.

"The existence of a guarantee and the extent to which an insurer can invest in assets to match the cash flows of the guaranteed payments are critical considerations"

Figure 5: Simplified illustration of the IAIS' analysis of exposure to substantial market risk



Source: IAIS Consultation Document — Non-traditional Non-insurance Activities and Products, 25 November 2015

For the assessment of substantial liquidity risk, the IAIS proposes consideration of:

- The delay period between repayment notification being received and payment actually being made; and
- The size of any economic penalty or fee that the insurer can apply as a result of the withdrawal relative to the gross value.

A short payment period (less than seven days) with no economic penalty could be classified as NTNI. A payment period of three months or more combined with an economic penalty of over 20% would not be classified as NTNI, but any other combination would require supervisory judgment.

The main criticisms levied by stakeholders to the proposals center around concerns that the systemic impacts have been overstated. For example:

- The document places too much emphasis on gross, rather than net, exposures (for example, the asset/liability matching principle can reduce net exposures to non-systemic levels)
- There is insufficient consideration of the timing of cash outflows (for example, insurers may have different payment periods for surrender payments depending on the volume of surrenders received)
- The analysis does not incorporate any probability analysis (for example, mass lapse events rarely occur); and
- The document does not clearly explain how the identified market and liquidity risk features are transmitted and pose systemic risk to the global financial system.

Higher Loss Absorbency (HLA)

The IAIS consulted on its initial HLA proposal in June 2015[9] and, following industry feedback, approved a final form[10] of the HLA at its Board meeting in November 2015. This milestone is seen as critical in ultimately achieving the objective of mitigating the systemic risk posed by G-SIIs to the global financial system.

HLA Capital Requirement

The HLA represents an additional capital requirement above the ICS that will apply to G-SIIs to address their systemic risk and act as an incentive for them to reduce their systemic footprint. However, a number of challenges remain, including the level of calibration, the extent to which risk sensitivity can be achieved through a factor based approach and the responsiveness of the HLA to underlying changes in the G-SII risk profile.

Although the intention is to use the ICS as the foundation upon which the HLA 'add-on' will apply, as it is not yet available in final form, the current design of the HLA uses the Basic Capital Requirement (BCR) as its foundation.

Based on field testing, the IAIS has identified that the BCR will need to be uplifted by approximately 33% to equate to the level of the ICS capital requirement. In order to smooth the transition from the BCR to the ICS, the baseline BCR will be increased by 11% per annum over 3 years (2016 to 2018). This uplift is capped in relation to regulated banking activities by reference to the appropriate Basel III capital ratio requirements.

The HLA adopts a factor-based approach, with the factors to be applied to the uplifted BCR (see Table 6) increasing depending on the 'bucket' to which the G-SII is allocated. The allocation of G-SIIs to buckets is dependent on the level of their own G-SII assessment score relative to the average of the G-SII scores of all potential G-SII assessed.

Given the work on the G-SII Assessment Methodology discussed above, the determination of the buckets and the allocation process may need to be reviewed once the 2016 methodology is finalized. However, the current HLA approach allocates the G-SIIs on the following basis, based on an assessment pool of 50 potential G-SIIs:

- Low bucket: G-SIIs with an assessment score below 0.04
- Mid bucket: G-SIIs with an assessment score between 0.04 and 0.06
- High bucket: G-SIIs with an assessment score of 0.06 or above (expected to be empty).

[9] IAIS Consultation Document on Higher Loss Absorbency capacity for Global Systemically Important Insurers (G-SIIs) published on 25 June 2015
[10] IAIS paper on Higher Loss Absorbency Requirement for Global Systemically Important Insurers (G-SIIs) published on 5 October 2015

Table 6: HLA required capital formula factors

BCR required capital exposure	Low Bucket	Mid Bucket	High Bucket
Traditional Life Insurance	6%	9%	13.5%
Traditional Non-Life Insurance			
Assets			
Non-Traditional Insurance	12%	18%	27%
Non-Insurance – Assets Under Management			
Non-Insurance – Other			
Non-Insurance – Regulated Banking	8.5%	12.5%	18.75%
Non-Insurance – Unregulated Banking	12.5%	18.75%	25%

Source: IAIS Higher Loss Absorbency Requirement for Global Systemically Important Insurers (G-SIIs), 5 October 2015

The HLA factors applying to life insurance, non-life insurance and assets are all the same implying that they broadly reflect a similar level of systemic risk. Additional emphasis is placed on NT and NI activities through the use of higher HLA factors as these activities are most likely to cause or amplify systemic risk events. Therefore, the definition of what constitutes NT and NI business becomes critical in determining the HLA factors that apply.

For regulated banking, the factors are set having regard to the uplift in risk weighted assets applied to global systemically important banks (G-SIBs). The factors for non-regulated banking activities are uplifted from the regulated banking factors.

The IAIS has indicated that, based on the factors adopted, the HLA is expected to result in an average increase in capital of 10% from the uplifted BCR requirement. However, the papers on both the G-SII assessment methodology and identification of NTNI activities discussed in the sections above are clearly highly relevant to understanding a G-SII's potential HLA charge. It is not yet clear how extensive any changes to the HLA design and calibration will need to be once these papers and the ICS are finalized.

HLA Capital Resources

The HLA element of the capital requirement will need to be met by the highest quality of capital. Given the current link with the BCR, this is currently taken to mean Core Capital as defined for BCR purposes. However, when the HLA's foundation changes to the ICS, the capital resources for HLA purposes will also be reviewed. Our expectation is that this then will become 'Tier 1 financial instruments for which there is no limit'.

For the combined BCR and HLA requirements, this will need to be covered by Core Capital and the minimum of additional capital and 50% of the BCR. The ratio of qualifying capital resources to the total capital requirement is expected to become a key metric.

"...the G-SII assessment methodology and identification of NTNI activities are highly relevant to understanding a G-SII's potential HLA charge."

Implications for Insurers

The extent of inter-connectivity between the G-SII Assessment Methodology, NTNI identification, the ICS and HLA are very clear:

- The work on the G-SII Assessment Methodology has transparency as one of its aims. This should enable greater understanding of the drivers of the G-SII assessment score, which will be critical to lowering individual scores and reducing capital add-ons. However, it remains unclear how quickly the G-SII Assessment score will respond to changes in the underlying systemic risk profile of insurance groups.
- As the IAIS has adopted a higher factor for NT activities compared to traditional insurance business, all current and potential G-SIIs should continue to monitor developments regarding the NT classification closely.
- As the ICS develops, the uplift applied to the BCR may change from the current 33% assumed. However, care will be needed to ensure that the potential revisions that will be required when the ICS becomes the foundation for the HLA do not result in a significant step change in the amount of HLA applied.
- The HLA bucketing approach is based on a relative assessment of G-SIIs. Given this is a very small population of groups, it is unclear how quickly an individual G-SII will be able to move to a lower 'bucket' of HLA factors. This could mean that while a particular G-SII's own systemic risk may have reduced over time, the same HLA factors could continue to apply.

The current work program in these areas makes it difficult for an insurance group currently to estimate what its likely capital requirements will be when the ICS becomes the foundation for the HLA. Although the HLA is intended to act as a deterrent to G-SIIs from taking on more systemic risk, it is currently unclear whether this will be achieved in practice. However, as the HLA calculation indicates an alignment of the calculation of capital requirements by business line, there is in an increased need to monitor capital metrics by product.

Finally, we believe that greater clarity should be provided regarding how the various capital requirements (BCR, ICS and HLA) and intervention levels (Minimum Capital Requirement (MCR) and Prescribed Capital Requirement (PCR)) will interact once all components are in force. For example, the BCR is currently designed as a factor-based approach while the ICS uses a stress and scenario based methodology to calculate capital requirements. These are very different approaches and it is unclear what role the BCR will have once the ICS is in place.

> "Although the HLA is intended to act as a deterrent to G-SIIs from taking on more systemic risk, it is currently unclear whether this will be achieved in practice."

Potential extension of G-SII requirements to Domestic Systemically Important Insurers (D-SIIs)

D-SIIs are those insurers which are important to the functioning of a domestic financial system. As such, failure of any of these institutions is expected to have a negative impact on the overall stability of the domestic financial system.

Similar to the global framework being considered by the IAIS for identifying and regulating G-SIIs, the US has in place a system for identifying Systemically Important Financial Institutions (SIFIs) which are the subject of enhanced regulation by the Federal Reserve. It is expected that some other local supervisory authorities may also implement some form of the framework being proposed by the IAIS for the regulation of D-SIIs within their own jurisdictions.

In this way, various components of the regulatory package applying to G-SIIs at a global level may also extend to D-SIIs. Amongst others, this includes a requirement to have in place a Recovery and Resolution Plan (RRP).

In terms of a Recovery Plan, insurers would need to describe their recovery options and governance framework including:

- Available options for dealing with financial stress as well as how and when these options would be triggered and what steps can be taken in practice and
- How the recovery monitoring and decision process is integrated within the risk management function.

Insurers, in concert with Resolution Authorities, would need to establish a Resolution Plan having regard for some of the considerations outlined below.

Figure 6: Key considerations of a resolution plan

Resolution Plan

Group and legal entity information

A thorough and detailed description of the institution's legal entity structure, providing details of how it relates to businesses, the group balance sheet, financial and operational interdependencies.

Economic Function identification

Information on the nature and scale of each core business line to establish the impact of the closure of that business on the relevant market's stability. This will assist the regulators to identify which s a Critical Economic function.

Plan for the continuation of the Critical Economic Functions

An elaboration of strategies on how each Critical Economic Function could be continued, focusing on financial, legal entity and operational interdependencies and implications for networks where appropriate

Overcoming barriers to resolutions

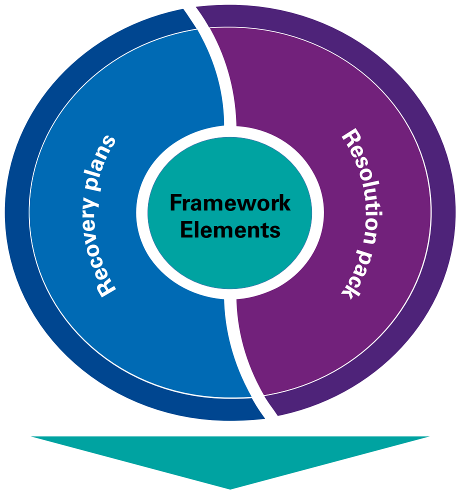
Identification of actions to address barriers to resolution identified. Solution plans should also outline the associated assessments of feasibility, costs, risks and implementation issues.

Source: KPMG International 2016

Figure 7: Summary of RRP requirements

Key supervisory requirements to:

- Identify options to recover financial strength and viability under severe stress
- Identify potential impact on the group structure and its ability to recover from loss event (at group and solo level) and in case of gone concern, its impact on resolution
- Undertake analysis of critical economic functions, particularly the impact of any NTNI business
- Extend the current processes for managing capital and liquidity under stress
- Demonstrate that the business model and risk appetite is capable of incorporating a 'Plan B'
- Provide for additional governance arrangements across the group



Operating model: key scope areas

- Effectiveness of strategic planning processes that incorporate resolvability perspectives
- Interconnectedness of a G-SII's/D-SII's operations on the broader financial services sector and consumers
- The financial and operational dependencies between:
  - significant legal entities
  - Critical insurance products and services and
  - Intra-group transactions and cash flow dependencies

G-SIIs/D-SIIs will be expected to achieve greater transparency with respect to the business model, increase regulatory acceptance and provide a tool for regulatory communication

- The right RRP programme should allow a G-SII/D-SII to demonstrate the effectiveness of its current risk management capabilities and arguement, where necessary, additional recovery optionality and resolution analysis via further identification and ability to remove any structural, financial and operational dependencies that may prevent key legal entities and/or critical products/services being separated from the rest of the organisation, where required.
- Demonstrating Board and Senior Management involement and understanding of the RRP plan will be fundermental in ensuring contined good governance, commercial and regulatory acceptance.

Source: KPMG International 2016

Contacts

Gary Reader
Global Head of Insurance
KPMG International
T: +44 (0)207 694 4040
E: gary.reader@kpmg.co.uk

Rob Curtis
Executive Director
KPMG in Australia
T: +61 418 901 666
E: rcurtis1@kpmg.com.au

Janine Hawes
Director
KPMG in the United Kingdom
T: +44 (0)207 311 5261
E: janine.hawes@kpmg.co.uk

Giles Williams
Partner
KPMG in the UK
T: +44 (0)207 311 5354
E: giles.williams@kpmg.co.uk

Robert Kasinow
Director
KPMG in the United States
T: +1 973 912 4534
E: rkasinow@kpmg.com

kpmg.com/socialmedia

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