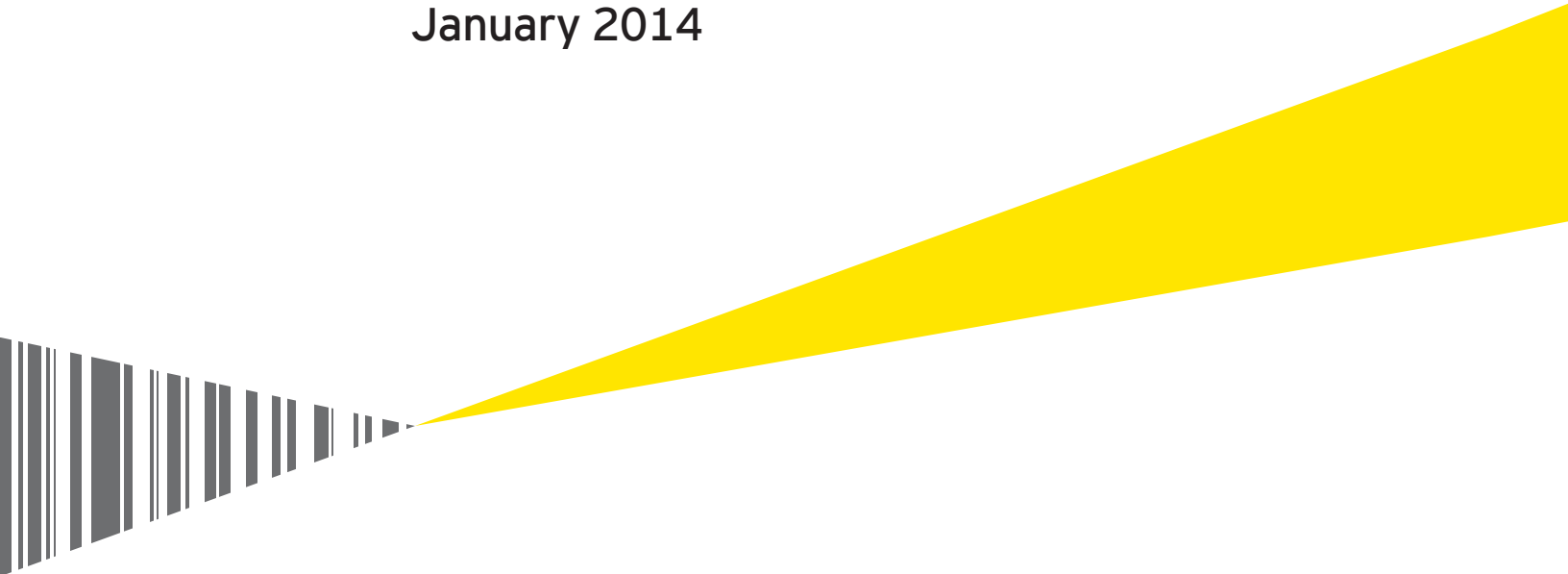


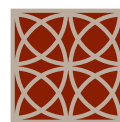
# Toward global standards for group supervision

Insurance Governance Leadership Network

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## Toward global standards for group supervision

*“Lack of coordination among supervisors is a main risk to effective supervision. As supervision of the group becomes more intense, with new standards and responsibilities, supervisors have to improve coordination. They have to delegate and understand each other. There are political reasons why this is hard, but it must be done.”*

– Insurance sector policymaker

The global financial crisis marked a significant change in the focus of financial-sector regulation. For the largest insurers, regulation has expanded beyond pure policyholder protection and, by extension, the solvency of individual companies, to promoting and protecting global financial stability. Regulators are also examining potential future risks in addition to historic risks or performance issues, with one supervisor noting, *“I challenge the aphorism that ‘if it is not broken, don’t fix it.’ We hear that all the time. You need to start early. You need time to work things out. When did Solvency II start? I am thankful it started early.”*

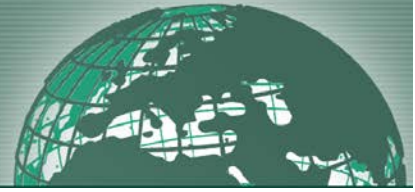
This shift in philosophy is at the heart of an important tension between supervisors and insurers. With respect to new regulations, several insurers echoed one director<sup>1</sup> who asked, *“What is the problem we are trying to solve? Have we had too many failures [of large insurers], or not enough?”* While few insurers failed in the crisis, policymakers and supervisors note that this sort of comment does not acknowledge the broader financial stability argument underpinning the development of new regulations. One supervisor said, *“I don’t want to puncture your optimism, but there is a lot of ‘insurance had a good war, didn’t we?’ Yes, but if we hadn’t supported bank bonds, what would have happened to your portfolio? Without massive public policy intervention, there would have been a problem ... Supervisors will expect increased resilience. We’d want to understand how good you’d be in another crisis without intervention.”*

To enhance stability, supervisors need a truly global view of firms’ activities. This demands much greater coordination within the insurance group, as well as by the dozens of supervisors that oversee the various parts of the largest insurers. Since the creation of the Insurance Governance Leadership Network (IGLN) in 2012, participants have expressed a sustained interest in the challenges and opportunities presented by the new focus on group supervision. On October 23 in London and November 14 in New York, IGLN participants convened to discuss the future of group supervision<sup>1</sup> and the new regulatory developments that both require and encourage better group supervision. Industry awareness of such developments as ComFrame,<sup>2</sup> global capital standards, recovery and resolution planning, and macroprudential supervision is uneven. One director noted, *“We have a new risk on the risk list – ComFrame.”* Others indicated their firms are aware of the debate over standards, but are unsure of the impact the new standards will have on them.

<sup>1</sup> In this document, “director” refers to non-executive, non-employee board members on a firm’s unitary or supervisory board.

<sup>2</sup> For more information on ComFrame, see International Association of Insurance Supervisors, [“Common Framework.”](#)

# Insurance Governance Leadership Network ViewPoints



Sixteen board members and executives of leading global insurers met in conversation with 11 members of the policy and supervisory community. The meetings focused on five broad themes, which are described in more detail in this issue of *ViewPoints*:<sup>3</sup>

- Regulation of complex insurers has fundamentally changed following the crisis
- Development of the first global insurance capital standards presents challenges and opportunities
- Recovery and resolution planning will test insurers, but could have important benefits
- Macroprudential supervision is not yet well defined or understood
- Effective supervisory coordination is more important than ever

## Regulation of complex insurers has fundamentally changed following the crisis

Participants agreed that prior to the crisis, supervision was much more focused at the legal-entity level, rather than the group level. Indeed, several insurers who participate in IGLN dialogues reported that they are just beginning to experience true group supervision. In addition, for the largest groups, the supervisory focus on the group and group solvency is as much on issues of possible market contagion as on policyholder protection.

In the pursuit of financial stability, policymakers and regulators are now considering not only the banking sector, but the financial system as a whole, including large insurers and shadow banking entities. One director spoke for several when he noted, *“As goes banking so too will go insurance. There is a desire and tremendous pressure for supervisors to fix what was broken in all financial sectors.”* For insurers, the emphasis on financial stability can be seen in the discussion of systemic risk and the designations of domestic and global systemically important insurers (G-SIIs),<sup>4</sup> as well as in recent papers on macroprudential risk in insurance.

## The roles of key supervisory and policymaking entities continue to evolve

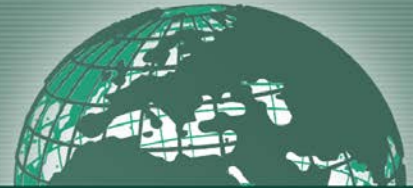
Efforts to improve oversight of the financial system have resulted in the growth and expansion of national, regional, and international authorities. IGLN participants have observed that the center of gravity in supervision is shifting more toward central banks, the G20, the Financial Stability Board (FSB), and the International Association of Insurance Supervisors (IAIS), with the IAIS leading the charge to develop G-SII regulations and insurance capital standards.

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<sup>3</sup> *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants’ comments appear in italics. For a complete list of summit participants, see Appendix 1, on page 16.

<sup>4</sup> For additional discussion of the systemic importance of insurers, see Insurance Governance Leadership Network, [“Exploring the Risk Environment: Regulatory, Macroeconomic and Other Top Risks,”](#) *ViewPoints*, July 3, 2013, 3–19.

# Insurance Governance Leadership Network ViewPoints



## Key regulatory and policymaking entities

- **European Insurance and Occupational Pensions Authority (EIOPA).** EIOPA is authorized to develop standards and guidelines. EIOPA is engaged in a number of initiatives, most notably the development of Solvency II, a new prudential and supervisory regime for the European Union. After more than a decade of development, on November 13 final negotiations cleared the way for an upcoming vote on Omnibus II, the legislation that will enact Solvency II in January 2016.
- **FSB.** The FSB was established in 2009 to coordinate the work of national authorities and international standards-setting bodies, largely on behalf of the G20. Members represent 24 countries and numerous standards-setting groups and are responsible for financial stability within their jurisdictions.<sup>5</sup> While the FSB's broad goals include strengthening global financial stability and promoting coordination and information exchange, its focus on systemically important firms is driving much of the FSB's influence in the insurance sector. The FSB played an essential role in the development of the G-SII label, approving designation criteria and, ultimately, the designations.
- **IAIS.** The IAIS is a voluntary-membership organization of insurance supervisors and regulators from more than 200 jurisdictions.<sup>6</sup> The IAIS issues global insurance principles, standards, and guidance, provides training and support, and organizes meetings for insurance supervisors. In recent months, with the support of the FSB, the IAIS's scope has expanded, and it has taken on a more direct role in global standards setting. In the past, the IAIS has largely provided voluntary principles and guidance, but it will now be responsible for developing policy measures and requirements, including several capital requirements, for G-SIIs and internationally active insurance groups (IAIGs).
- **National entities.** In some countries, (France, for example) stand-alone insurance supervisors have merged with banking counterparts. In the United Kingdom, policymakers moved insurance regulation into the central bank and split prudential and conduct regulation between two new entities. Perhaps the most significant changes have occurred in the United States, where the Federal Insurance Office (FIO) was established and authorized to monitor the insurance sector and to represent the United States on prudential aspects of international matters. Recent legislation also appointed the Federal Reserve Bank (the Fed) as consolidated supervisor of insurers that are designated as domestic Systemically Important Financial Institutions (SIFIs), as well as those entities that have savings and loan holding companies. The Fed already exerts substantial influence on international insurance matters, as Fed Governor Daniel Tarullo chairs the FSB's Standing Committee on Supervisory and Regulatory Cooperation – the committee charged with insurance oversight. Finally, the Financial Stability Oversight Council (FSOC) was established to designate insurers as domestic SIFIs and oversee matters of financial stability in the United States.

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<sup>5</sup> Financial Stability Board, "[Member Institutions.](#)"

<sup>6</sup> International Association of Insurance Supervisors, "[About the IAIS.](#)"



## **The combination of new supervisory goals and actors raises several issues**

Over the last several meetings of the IGLN, insurers have raised key questions regarding the new supervisory landscape, which will need to be addressed in the near future as new capital and supervisory standards come into effect. Executives and boards need to understand the shifting supervisory configuration in order to plan effectively for the future. IGLN participants identified the following key questions:

- **How standardized should approaches be across geographies and lines of business?** Unlike banks, insurers have not had a global capital standard to date. One policymaker observed, *“We recognize that businesses are different – long tail, short tail, life, non-life, etc. We’d like to reflect that. A fundamental question is how many differences should be reflected?”* The IAIS has proposed setting several baseline capital standards, but national approaches may allow for some deviation from these.
- **How much coordination should exist among supervisors?** One director noted, *“We have [dozens of] different regulators ... We don’t mind being regulated; we just want better coordination.”* To ease reporting burdens and improve group supervision, key national authorities will need to coordinate more than they have in the past. However, this raises information-sharing, confidentiality and trust challenges within the authorities and insurers. To what degree should supervisors formally or informally share information? Where is the line between promoting sharing and preserving confidentiality? Beyond simple information sharing, how do authorities develop longer-term trust?
- **How should bank-regulatory tools be adapted for use in insurance?** Insurers questioned the extent to which the recent reforms in the banking sector are appropriate for insurance supervision, expressing concern, for example over application of recovery and resolution planning (RRP) and metrics such as leverage ratios. Supervisors, by contrast, suggested that lessons learned in banking can be quite applicable to insurance. If tools first used in banking are applied to insurers, what sort of modifications and training will be required?
- **How will authorities resolve political challenges to achieve agreement?** There are important disagreements across and within national borders. Observers say that achieving consensus among supervisors – the historic approach of the IAIS – could take decades, especially given the experience with Solvency II. Instead, the FSB has laid out a much faster timetable for new standards. How will the development process achieve consensus or critical mass and meet the FSB’s deadlines? What are the consequences of lack of agreement or a slow process? With respect to creating global capital standards, one European supervisor remarked, *“The US is a challenge. They are between a rock and a hard place because they will face a capital shock.”* One regulator noted the complexities of the US system to highlight these issues: *“It’s important to remember that if 42 state commissioners don’t buy in, ComFrame will not pass in the United States. After the commissioners, you need 42 state legislators and then 42 governors to support it. I’m not concerned about the ability of states to work with the Fed, but we need agreement about certain things ... If the US doesn’t implement ComFrame, will others? The US is the largest market.”*

# Insurance Governance Leadership Network ViewPoints



## To enhance coordination, supervisors can focus on a few key ingredients

IGLN participants agreed that a number of related elements are necessary to help improve group supervision and supervisory coordination:

- **Clear lines of authority among supervisors.** Specifically, participants mentioned the need to define the roles and responsibilities of home and host supervisors, expectations for communication and decision making, and the structure of supervisory colleges. To illustrate, one supervisor said, *“The [supervisory] college framework can be made to work better. There are core members and peripheral members and then the college itself. You cannot have a meeting with 42 people. That needs to be worked out. Maybe the core is four or possibly six.”*
- **Greater convergence of core standards.** Currently solvency and accounting standards differ widely by region and country. The introduction of Solvency II will modernize solvency requirements in Europe, but those standards will still differ from standards in the United States and other parts of the world. Supervisors in Australia, China, Mexico, Singapore, and South Africa are developing new solvency standards that may or may not clearly align with Solvency II. Furthermore, a lack of convergence between Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) continues to present management challenges and hamper comparability.
- **Better information sharing.** Information sharing can benefit supervisors and insurers. For supervisors, it enables better decision making and promotes trust among participants. A supervisor noted, *“There is a vulnerability if you are not in the core, so we have to be much better about how we cascade information.”* For insurers there can be a significant cost to redundant reporting. One executive noted, *“Any large insurer will have to share information multiple times because of confidentiality requirements or something else. There is a cost to that.”* However, insurers also want to understand how and when information they provide to one supervisor might be shared with others.
- **Trust.** Perhaps the most challenging and essential ingredient is mutual trust. Many directors noted that even in times of relative calm, national supervisors can be almost exclusively focused on their own policyholders, rather than on global stability, which leads to balkanization of standards and supervision. Some supervisors fear unequal treatment of home and host stakeholders in a stress scenario, and both insurers and supervisors suggested that national authorities are likely to take action to protect their constituents, causing harm to other jurisdictions. Clarifying rules of engagement under stress and promoting collaboration and information sharing are two ways to increase trust.

New global principles and standards may need to be flexible to accommodate legacy issues and variation in markets due to company structures or lines of business, but all parties agree on the important benefits of a level playing field and greater harmonization. As insurers look to the immediate future of regulation, the two most salient issues are development of global capital standards and the implementation of recovery and resolution planning.





## Development of the first global insurance capital standards presents challenges and opportunities

Both supervisors and insurers support convergence of group capital standards. Both believe that ending the current fragmented approach to capital is a necessary first step towards global standards. In a speech to the IAIS, Jaime Caruna, general manager of the Bank for International Settlements, asserted, “You cannot effectively supervise globally active firms without having a consistent, comparable quantitative standard.”<sup>7</sup> Andrew Bailey, deputy governor of the Bank of England and chief executive of the Prudential Regulation Authority, later observed that “[a global capital standard] is critical because if we get this right, we can deal more effectively with issues of cross-border recognition, and more generally seek to simplify the capital regime. The prize is therefore big, and firms need to be involved with us in the work.”<sup>8</sup>

### More comprehensive standards will be developed by 2016 and take effect in 2019

The IAIS has recently announced that it is developing three separate capital measures for large insurers. Each of the measures will be submitted for consultation and field tested prior to implementation.

- **Basic capital requirements (BCR).** On December 16, the IAIS released for comment its basic capital requirement proposal for G-SIIs. Prior to the consultation this standard was called the “backstop standard.” The BCR is designed to improve resilience to stress and aid in comparability across jurisdictions. The BCR will apply to the entire book of business. The BCR is intended to reflect only major risk categories and provide a minimum measurement to underpin the overall capital assessment.<sup>9</sup>
- **Higher loss absorbency (HLA).** HLA is designed to improve the resiliency of G-SIIs and to reduce the probability of a failure. The BCR will form the foundation upon which HLA requirements will be built. According to one policymaker, “*HLA sits on top of the [basic capital] requirements, and the focus is just non-traditional and non-insurance activities.*”
- **Insurance capital standard.** In October, the IAIS committed to developing a risk-based insurance capital standard.<sup>10</sup> The standard will apply to IAIGs – those groups subject to ComFrame – which could include approximately the 50 largest global insurers.<sup>11</sup>

<sup>7</sup> Jaime Caruna, “[Insurance and Financial Stability: a Basel View](#)” (speech before the International Association of Insurance Supervisors, Bottmingen, Switzerland, March 20, 2013).

<sup>8</sup> Andrew Bailey, “[Meeting the Challenges of a Changing World – the View from the PRA](#)” (speech at the Association of British Insurers Biennial conference, London, July 9, 2013), 7–8.

<sup>9</sup> International Association of Insurance Supervisors, [Basic Capital Requirements for Globally Systemically Important Insurers \(G-SIIs\): Proposal](#) (Basel: International Association of Insurance Supervisors, December 16, 2013).

<sup>10</sup> International Association of Insurance Supervisors, [The IAIS Insurance Capital Standard: A Global Response to a Global Issue](#) (Basel: International Association of Insurance Supervisors, 2013), 2.

<sup>11</sup> IAIGs will be designated by national authorities but must meet certain criteria related to international activity and size. Specifically, insurers must have premiums that are written in at least three jurisdictions; gross premiums written outside the home jurisdiction must be at least 10% of the group’s total gross written premium; and total assets of not less than US\$50 billion, or gross written premiums of not less than US\$10 billion. International Association of Insurance Supervisors, [Common Framework for the Supervision of Internationally Active Insurance Groups: For Consultation](#) (Basel: International Association of Insurance Supervisors, 2013), 2.

# Insurance Governance Leadership Network ViewPoints



Deadlines	Requirement	Application
2013	Development of the basic capital requirement	G-SIIs, possible application to IAIGs
2014	Testing and endorsement of the basic capital requirement (endorsement by IAIS, FSB, and G20)	
2015	Development of higher loss absorbency	G-SIIs
2016	Development of insurance capital standard	IAIGs
1 January 2019	Implementation of higher loss absorbency, insurance capital standard	G-SIIs, IAIGs

Regulators acknowledge that the aggressive timelines will create challenges for insurers and supervisors alike. Historically, development of complex and significant standards has taken much longer: European policymakers have taken over a decade to develop Solvency II standards, and regulators have developed comparable Basel capital standards for banks over several decades. One non-executive remarked, *“This is Basel [capital standards] for insurance. That makes some sense, but how long have they been working on Basel?”* Several supervisors and policymakers stressed that while the current process is accelerated, it still will be iterative and allow for refinement over time. One executive noted, *“They are on Basel III. We won’t get to that overnight. This is just a first cut.”* Regarding the timeline for the BCR, one policymaker noted, *“The IAIS consultation paper will include thoughts and options. It won’t be the final word. It will guide how we do field testing so we can determine what data are available to support it.”* The current process is fast-tracked and early input is essential; however, the BCR and other standards will be refined over time.

## **Most insurers concede that capital standards are inevitable and will have value**

Insurers and supervisors generally agree that new capital requirements are inevitable. One participant noted, *“IAIS has transitioned from ‘if’ to ‘how.’ The insurance capital standard, [basic capital] standard, higher loss absorbency – all of these standards are in the same situation. It may be slightly aspirational, but drafts will happen soon.”* One supervisor suggested that once a standard is promulgated, insurers will adopt it: *“How can insurers not measure themselves against a standard if others are? The bottom line is that this makes it very important to get the standard right.”*

Furthermore, IGLN participants mainly agreed that standards will promote transparency and trust. One executive emphasized the importance of group capital in this regard, saying, *“It’s hard to argue that you don’t need a consolidated view or that you can take risks in non-core areas and not understand the impacts.”* Participants agreed that the BCR would provide a check on internal models, helping to ensure the accuracy of those models. The insurance capital standard and G-SII HLA requirements should allow for risk-sensitive comparison across firms and geographies.





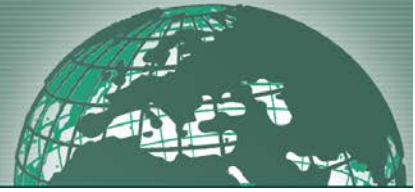
## Insurers are concerned about the development process and outcomes

Though the majority of insurers seem to accept the inevitability of capital standards, and some even welcome them, IGLN participants have raised a number of concerns.

- **Finding the correct calibration.** Insurers remain concerned about how capital standards will be set and measured, especially given the incomplete convergence of capital and accounting standards. One supervisor asked, *“How do we get [to capital standards] without commonality in accounting standards? How do we get there with different solvency standards?”* Another director commented, *“It is not conceivable to do all of the work in the time frame if it starts from scratch. We will need to use existing standards to come up with new ones. What will the basis be?”*
- **Preserving risk sensitivity.** The recent BCR proposal likely allays the fears of some IGLN participants who worried that the IAIS would opt for a simple standard, such as blunt leverage ratios, for the basic capital requirement. The proposal indicates that Basel-type leverage ratios are not appropriate for insurance and comments, *“using [a Basel ratio] would not only not be informative but may well provide results which are inconsistent with the current best practices of insurance risk management.”*<sup>12</sup> Insurers and supervisors agree that capital measures need to be risk adjusted, with one supervisor saying, *“In banking there is a clear message: ‘we want more capital.’ Insurance can’t be so clear because there are 120 approaches to solvency. The important question is not if the capital level should be more or less, but is it risk based?”* IAIS acknowledges the tension between simplicity, comparability, and risk-sensitivity in developing the BCR. IAIS currently proposes a factor-based approach, which will account for risks resulting from assets, liabilities, and non-traditional, non-insurance activities. At present, IAIS estimates there will be between five and 10 factors included in the BCR.<sup>13</sup> While this number of factors allows for some risk sensitivity, it may cause concern for some insurers who would favor more sensitivity.
- **Working within an abbreviated time frame.** One supervisor noted, *“There really isn’t a choice. Standards have to come fast.”* Directors and supervisors agreed that the time allotted for creation of a preliminary basic measure for G-SIIs is extremely short – indeed, one director said achieving it would set *“a land speed record.”* This director suggested that *“people haven’t had enough time to think this through, so they can’t coalesce.”* Insurers worry that the demanding deadlines will constrain participation and lead to errors and problems with the standards. According to one director, *“Trying to get everyone on board is an elongated process, and that is a problem.”* The IAIS relies on field testing to refine new standards, but as one supervisor observed, *“There’s not a lot of time to fix anything if there’s a problem.”* While these are important objections, participants also acknowledge that other processes, notably Solvency II, stalled. Policymakers have to balance speed and accuracy, since loss of momentum can also challenge the viability of regulations.
- **Maintaining a clear voice in the process.** The limited time for comment is one of several factors leading insurers to worry that they may not have a sufficient voice in the process. One supervisor remarked that *“this process will occur with or without the active collaboration of the industry”* – which

<sup>12</sup> IAIS, *Basic Capital Requirements for Globally Systemically Important Insurers (G-SIIs): Proposal*, 21.

<sup>13</sup> *Ibid.*, 8.



spurred IGLN insurers to emphasize the need for the industry to collaborate and provide meaningful feedback to key decision makers.

Participants also observed that in recent months, policymaking has shifted away from local regulators and toward the FSB and G20, groups without historically strong ties to the insurance industry. One non-executive asked, *“At the FSB level, is there enough dialogue to move the insurance process forward correctly? How do we ensure there is more dialogue there?”* Participants were concerned that if decision makers lack strong relationships with insurers, the requirements they develop may adversely affect insurers and insurance customers without significantly improving financial stability.

In addition, insurance is a heterogeneous industry with important differences across geographies and lines of business, making it difficult to achieve consensus and critical mass on issues. Underscoring the current challenge, one executive remarked, *“The industry knew the capital standard was coming. That wasn’t news. We just can’t get together. G-SIIs couldn’t get together. The IAIGs have had a conversation, and people got up and left ... The forums collapsed. We need a clear objective.”* Participants encouraged more involvement from leading global insurers, with one supervisor stressing the need for visible chief executive officer and C-suite leadership rather than the traditional reliance on government relations personnel or trade groups.

## **Recovery and resolution planning will test insurers, but could have important benefits**

Perhaps nowhere is the issue of coordination and trust more important than in planning for the resolution of a large global financial institution. Banks were the first institutions to go through the RRP process, but recent guidance from the FSB suggests large insurers – not just G-SIIs – will follow soon.<sup>14</sup> Although some argue that insurers are not systemic and do not face immediate dangers like those that threaten banks, the FSB disagrees. It argues that traditional portfolio transfer and run-off tools may be insufficient to address the systemic impact that the failure of certain insurers could have, and therefore RRP is needed.<sup>15</sup> Many in the industry also speculate that national authorities may begin requiring RRP as well. The Prudential Regulation Authority (UK) and the Office of the Superintendent of Financial Institutions (Canada) have already begun requiring insurers to report on impediments to resolution or to develop RRP.<sup>16</sup>

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<sup>14</sup> See Financial Stability Board, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions: Consultative Document* (Basel: Financial Stability Board, 2013).

<sup>15</sup> *Ibid.*, 9.

<sup>16</sup> Hugh Coelho, “Insurers Must Prepare for Far Reaching ‘Living Wills’ Requirements,” *Insurance Risk*, July 10, 2013.



## Recovery and resolution planning for insurers<sup>17</sup>

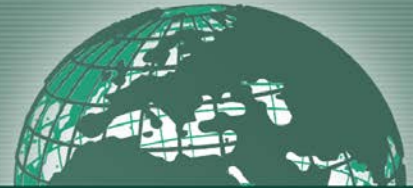
- Initially, G-SIIs will need to review and update recovery plans, work with their crisis management groups to establish resolution plans, and prepare for resolvability assessments. FSB guidance and ComFrame suggest that resolution planning will eventually extend to other IAIGs as well.
- Resolution planning will have to assess and address the challenges to resolution holistically:
  - How does the enterprise's legal structure complicate resolution locally and globally?
  - How can non-traditional and non-insurance activities best be separated from traditional insurance activities?
  - What are the uses and limitations of traditional resolution tools (portfolio transfers and run off) for traditional activities?
  - What is the state of policyholder protection and guarantee schemes (or similar arrangements) in the enterprise's jurisdictions?
- Proposed new resolution tools for authorities will include additional powers to split or change businesses, to change the terms of existing contracts, to restructure liabilities, and to bail in creditors.<sup>18</sup>
- G-SIIs must develop RRP by the end of 2014. Timelines for other insurers are not set yet.

Over the course of the two meetings, participants began to approach consensus on the nature of RRP, what it can and cannot do, and what it could mean for insurers:

- **Resolution and recovery are very different processes.** Many insurance industry participants stress that recovery and resolution planning are two different processes. *“They are not one word. Recovery includes the parade of horrors and what you will need to do to reliquify and stay solvent. Resolution is what you do if you get killed,”* noted one director. Participants all agreed that recovery planning and resolution planning should be addressed individually, both internally and with supervisors.
- **The process is more valuable than the output.** According to one executive, *“The value in it is the process of developing the plan. The output isn't the point. The process is.”* The degree of market disruption needed to cause the death of a global insurer is so significant that it is difficult to imagine

<sup>17</sup> For additional information on RRP, see EY, [Recovery and Resolution Planning: Spotlight Moves on to Insurers](#), Senior Executive Update (London: Ernst & Young Global Limited, 2013); and Hugh Coelho, [“Insurers Braced for Far-Reaching Recovery and Resolution Requirements,”](#) Insurance Risk, September 12, 2013.

<sup>18</sup> “Bail in” is a new regulatory tool that would allow regulators to impose losses on bondholders while leaving other creditors of similar stature, such as derivatives counterparties, untouched. Bail in is designed to address the shortfalls of failing financial institutions quickly to help stabilize the financial system. Contingent convertible bonds (CoCos) are an example of a bail-in instrument. CoCos typically convert from debt to equity if certain specified levels, such as capital levels, are breached, allowing distressed institutions to raise capital.



scenarios in which it might occur or to make assumptions about capital market conditions and available resolution options. A director said, *“You can’t assume a plan will work. If a major company goes down, what is the chance that there won’t be five, 10, or 15 other firms with it? There won’t be buyers, and the options you think are there won’t be.”* If the plan might not work in a crisis, one director asked, *“Is RRP just a theoretical exercise?”* Both supervisors and insurers were pessimistic, agreeing with one director, who said, *“As sure as night follows day, we won’t have the right plan.”* Despite concerns about the RRP processes, many participants agreed with one industry expert who said, *“The point is to demonstrate you can be resolved, not how.”*

- **RRP can improve management.** According to several directors, the main value of RRP is improved planning for the insurer. *“Companies probably have too much belief in their own business models. RRP could be a good thing in that context. Maybe it helps as long as management doesn’t get to choose the scenarios,”* said one director. Effective resolution planning can shine a spotlight on possible vulnerabilities and opportunities to streamline operations. An executive elaborated, saying, *“It is expensive, but you get a better view of structure, intersections, and dependencies.”* While there was some disagreement regarding the management benefits of resolution planning, the value of recovery planning and related stress testing is especially clear to participants. Furthermore, most agreed recovery planning and stress testing should be part of standard operations. *“Stress testing is essential because it shows you that you can handle mayhem. Supervisors need to see that; boards should want to see that. So should markets,”* said one director.
- **RRP will increase mutual trust and understanding.** Better and more transparent planning creates important second-order benefits. One supervisor said, *“Resolution planning gives me comfort that capital isn’t trapped in a crisis. That is an important benefit.”* A director observed that *“resolution is an extreme scenario”* and suggested that knowing insurers could envision and plan for such a scenario *“should give regulators some comfort.”*

As familiarity with RRP grows, insurers remain concerned about the following potential challenges:

- **RRP will not be sufficiently tailored to insurers, relative to banking.** Insurers have argued that many of the postcrisis regulatory tools developed for banks should not be applied to insurers or, at a minimum, should be carefully modified. This argument may be particularly salient with respect to resolution planning. One regulator observed, *“We’ve never seen the failure of a life company in a weekend. It’s legitimate to ask if [regulators are] imposing banking-style regulation on insurers unnecessarily. Maybe we should be more focused on recovery and [own risk and solvency assessment].”* If RRP should be modified for use in the insurance sector, what would that modification entail?
- **Supervisors may rush to use resolution tools, creating additional harm.** Many insurance liabilities have long time horizons, allowing adequate time to regain profitability and stability. Directors are concerned that supervisors might rush to use resolution tools, altering liability structures and possibly damaging policyholders or destroying value. One expert said, *“If [supervisors demand resolution] too quickly, the policyholders are the ones hurt.”* A director added, *“You don’t run an auction when everyone’s prices are depressed. You take some time.”* In addition, the self-correcting nature of property



and casualty insurance helps ensure an influx of capital after a significant event. As one director noted, *“Winds blow, waters crash, earth moves. The more adverse the scenario, the more regulators should expect an infusion of capital.”*

- **RRP could raise the cost of capital, risk transfer, and products.** Experts speculate that the existence of certain RRP tools, even if they are not used, could change insurers’ relationships with counterparties and influence risk models and customer pricing. Authorities’ ability to restructure liabilities, use bail in, and set trigger points could increase the cost of capital for insurers. In addition, if authorities can change termination clauses, forcing counterparties to work with distressed insurers, counterparties will price that risk into contracts. Likewise, if authorities are able to restructure existing contracts by limiting guarantees, converting products, or eliminating early surrender, insurers will need to reassess product risks and pricing. Existing capital models are calibrated to maintain required capital for solvency, not to account for insolvency and resolution scenarios.
- **If national legal requirements cannot be bridged, RPP could be an expensive and unproductive exercise.** RRP planning will be expensive and may not be useful if it cannot adequately account for legal requirements across geographies. Insurers and supervisors worry that RRP activities could end up as no more than a complicated exercise, given existing rules for movement of capital and local bankruptcy and liquidation laws, instead of a good guide to managing distress. One CRO commented, *“You can have a resolution plan in place, and 98% of regulators will still require local approval. They’re not going to pre-approve anything. Every capital transfer still needs sign-off. RRP is a good exercise, but it’s just an exercise.”*

## Macroprudential supervision is not yet well defined or understood

A recent IAIS paper on macroprudential supervision signals a continued focus on the potential systemic impacts of insurance products and operations.<sup>19</sup> One risk chair observed that the Basel Committee has also produced a paper on longevity risk transfer, raising the topic as a possible insurance risk that could affect financial stability.<sup>20</sup> The IAIS’s stated goal for macroprudential supervision is to “[enhance] supervisory capacity to identify, assess and mitigate macro-financial vulnerabilities in areas of economic significance to the global insurance sector where the impact of disruptions to financial stability are deemed most severe and wide-spread.”<sup>21</sup> In the future, the IAIS will issue additional guidance on the application of macroprudential techniques, including a toolkit of early-warning measures for use in stress testing.

To date, macroprudential supervision has been within the jurisdiction of central banks and largely applicable to the banking sector. Federal Reserve Board Governor Sarah Bloom Raskin broadly defined macroprudential tools as “capital regulation [including stress testing], liquidity regulation, regulation of

<sup>19</sup> International Association of Insurance Supervisors, *Macroprudential Policy and Surveillance in Insurance* (Basel: International Association of Insurance Supervisors, 2013).

<sup>20</sup> Basel Committee on Banking Supervision, Joint Forum, *Longevity Risk Transfer Markets: Market Structure, Growth Drivers and Impediments, and Potential Risks* (Basel: Bank for International Settlements, 2013).

<sup>21</sup> International Association of Insurance Supervisors, *Macroprudential Policy and Surveillance in Insurance*, 5.





margins and haircuts in securities funding transactions, and restrictions on credit underwriting.”<sup>22</sup> However, even in banking, supervisors and observers seem to agree that the philosophies and tools for macroprudential supervision remain underdeveloped. Some financial industry observers note that macroprudential tools will be much more unpredictable and discretionary than historical company-focused standards and interventions. As one banking regulator noted, “It is far from clear how macroprudential will work.”<sup>23</sup>

### **How macroprudential supervision will affect microprudential regulation is unclear**

Given the state of macroprudential supervision in the more established banking sector, many participants seemed to agree with one director who asked, “*What does macroprudential surveillance of insurance really mean?*” Several directors question to what extent macroprudential supervision could or should be used on insurers.

Supervisors and policymakers acknowledged they are still in the beginning stages of defining this new area of supervision. One supervisor asked, “*What is ‘macro’ and what is ‘micro’?*” A director followed with another question: “*Will a macroprudential supervisor tell us our investment portfolio is misallocated?*” While G-SII designations are institution specific, supervisors envision macroprudential oversight applying to types of activities that may span multiple sectors and institutions. Issues and events addressed through macroprudential examination need not be of a magnitude to threaten firms’ solvency. One supervisor gave as an example the contribution of mortgage underwriting standards to the overheating of real estate markets.

### **The politics of macroprudential supervision may complicate its implementation**

Several participants observed that one of the challenges of macroprudential supervision is its potential political dimension. One banking regulator noted, “We have to recognize the political economy within which macroprudential operates. It is much harder than monetary policy. The objectives are not as clear, and the levers are not easy to describe to people. By contrast, monetary policy has one or two relatively simple objectives ... [In politics] there are many competing policy objectives – inducing homeownership, promoting growth and ensuring the system is safe. The policy issues are deep and complicated.”<sup>24</sup> One IGLN participant highlighted the tension between monetary and political policy when he asked, “*Would a supervisor tell a company they are overexposed to sovereigns – either their own or others?*”

### **Effective supervisory coordination is more important than ever**

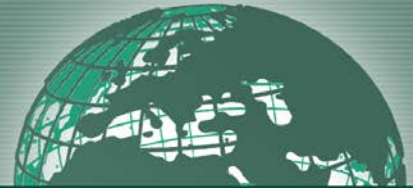
Participants suggested that clearer lines of authority and communication among the many supervisory stakeholders, true global standards, and better information flow would go a long way toward improving group supervision. Global capital standards, RRP, and macroprudential supervision offer ways to both improve and test supervision of the largest global insurers. As individual authorities take on new roles and pursue new agendas and approaches to regulation, coordination becomes increasingly important. During the

<sup>22</sup> Sarah Bloom Raskin, “[Beyond Capital: The Case for a Harmonized Response to Asset Bubbles](#)” (speech at the Exchequer Club Luncheon, Washington, DC, July 17, 2013).

<sup>23</sup> Banking Governance Leadership Network, “[Five Years on, Uncertainty Is the New Normal.](#)” *ViewPoints*, December 2013, 37. Macroprudential supervision in banking is discussed in depth on pages 37–43.

<sup>24</sup> *Ibid.*, 38.





October and November IGLN meetings, directors highlighted the following benefits deriving from improved coordination:

- **Capital efficiency.** Some directors assert that divergent capital standards will require insurers to manage to the highest denominator regardless of models or other information. One director said, *“There is a tendency to be more conservative the more that comes at you. It gets into the corporate psyche. We curtail discussions if it seems too punitive from a capital perspective.”* Better coordination and standardization could improve capital efficiency, reducing the likelihood of overcapitalization, higher prices, or financial exclusion.
- **Elimination of conflicting standards.** One CRO observed, *“Standards need to converge, but they won’t be completely aligned. We will all be running the firms to different standards. That is just part of running a large business. The trouble is when standards conflict.”* Beyond capital, one director noted that common resolvability schemes could improve insurers’ ability to create a meaningful unitary resolution plan, for example.
- **Limiting of regulatory arbitrage.** One director observed that despite efforts to create common standards, *“the biggest problem may be the loopholes that are created in various countries for their own benefit. This is a tremendous tension. Everyone tries to cut corners on assets when it’s to their benefit.”* When authorities relax standards, it can create additional risk and undermine trust. One CRO said, *“There is a real need for a consistent framework that operates globally. If we don’t have it, we get balkanization and small players playing to regulatory arbitrage.”*
- **Promotion of cross-border comparability for investors and supervisors.** Transparent and meaningful standards for capital, supervision, and accounting will help investors and supervisors make more informed decisions. However, insurers acknowledge that convergence of solvency and accounting standards is highly unlikely in the near term.
- **Reduction in hard and soft costs.** All new regulations carry both direct and hidden costs. The direct costs of regulation, including the staff and infrastructure needed to meet new requirements, are increasingly burdensome. A recent report by Allianz Global Investors estimated that institutional investors forfeit 2.3% of returns due to regulatory costs and constraints.<sup>25</sup> To the extent that a lower return is correlated with lower risk, this may be an acceptable outcome. Some insurers assert that some increased standardization across regimes could reduce the cost of compliance without increasing risk.

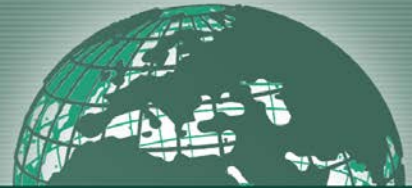
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Supervision of the largest global insurers is going to focus increasingly on global financial stability, which will require better group supervision and supervisory coordination. Efforts to develop global capital standards, recovery and resolution planning, and macroprudential supervision provide a test of coordination and offer possible pathways to improve it. Participants in the recent IGLN meetings acknowledge that traditional methods of engagement with policymakers may no longer be sufficient, and they hope to encourage their organizations and others to become more involved in current policy development to help ensure that new

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<sup>25</sup> Allianz Global Investors, *Prepare for Landing*, Global RiskMonitor (Frankfurt am Main: Allianz Global Investors, 2013), 20.

# Insurance Governance Leadership Network ViewPoints



regulations promote stability without sacrificing innovation or reducing the availability of reasonably priced insurance.

## About the Insurance Governance Leadership Network (IGLN)

The IGLN addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages members of senior management, policymakers, supervisors, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy insurance institutions. The IGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the IGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers, and stakeholders who become engaged in this leading-edge dialogue, the more value will be created for all.

## About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

## About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

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## Appendix 1: Meeting participants

### Directors and executives

- Michael Arnold, Board Risk Committee Chair, Group Audit Committee Member, and Nomination Committee Member, Old Mutual
- Irving Bailey, Vice Chairman, Supervisory Board, Risk Committee Chair, Compensation Committee Member, Supervisory Board Member, AEGON NV
- Richard Booth, Audit and Conduct Review Committee Member, Risk Review Committee Member, Sun Life Financial
- David Cole, Group Chief Risk Officer, Group Executive Committee Member, Swiss Re
- John Fitzpatrick, Audit Committee Member, Finance and Risk Committee Member, American International Groups
- Kirstin Gould, Executive Vice President, General Counsel, and Secretary, XL Group
- Jan Holsboer, Supervisory Board Committee Member, NN Transition Committee Chair, Audit Committee Member, Risk Committee Member, ING Group
- Roger Marshall, Audit Committee Chair, Board Risk Committee Member, Nomination Committee Member, and Remuneration Committee Member, Old Mutual
- Steve Miller, Chairman, American International Group
- Bruce Moore, Audit Committee Chair, China Life
- Pete Porrino, Executive Vice President and Chief Financial Officer, XL Group
- Paola Sapienza, Investment Committee Member, Risk and Control Committee Member, Assicurazioni Generali
- Raj Singh, Group Chief Risk Officer, Standard Life
- Paul Smith, Executive Vice President, Treasurer, and Chief Financial Officer, State Farm Mutual
- Douglas Steenland, Regulatory, Compliance, and Public Policy Committee Chair, Finance and Risk Committee Member, American International Group
- David Weymouth, Group Chief Risk Officer, RSA Group

### Regulators, supervisors, and policymakers

- Julian Adams, Deputy Head and Executive Director Insurance, Prudential Regulation Authority
- Jim Doherty, Senior Director, Life Insurance Group, Office of the Superintendent of Financial Institutions

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- Jules Gribble, Principal Administrator, International Association of Insurance Supervisors
- Lauren Hargraves, Senior Vice President and Senior Supervisory Officer, Federal Reserve Bank of New York
- Robert Hingley, Director, Investment Affairs, Association of British Insurers
- John Huff, Director, Missouri Department of Insurance, Financial Institutions and Professional Registration, Financial Stability Oversight Council, and Member, National Association of Insurance Commissioners
- Thomas Leonardi, Commissioner, Connecticut Insurance Department
- Steven Manzari, Senior Vice President, Financial Institutions, Federal Reserve Bank of New York
- John Maroney, Head of Financial Stability, International Association of Insurance Supervisors
- Patrick Montagner, Director, Autorité de contrôle prudentiel et de résolution, Banque de France
- Carlos Montalvo, Executive Director, European Insurance and Occupational Pensions Authority

## EY

- Martin Bradley, Global Insurance Risk and Regulatory Leader
- Shaun Crawford, Global Insurance Sector Leader
- Mark Robertson, Partner, Head of UK Insurance Sector
- John Santosuosso, Global and Americas' Insurance Assurance Practice Leader
- Tom Ward, Partner, Advisory Services

## Tapestry Networks

- Dennis Andrade, Principal
- Leah Daly, Senior Associate
- Peter Fisher, Partner
- Mark Watson, Partner