Financial Services Management

Global Insurance Capital and Prudential Standards

Cite
International Association of Insurance Supervisors
Fact Sheet
The IAIS Insurance Capital Standard: a Global Response to a Global Issue
Frequently Asked Questions for IAIS Financial Stability and
Macroprudential Policy and Surveillance (MPS) Activities
Frequently Asked Questions for the IAIS Common Framework for the Supervision of
Internationally Active Insurance Groups (ComFrame)

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Overview

The International Association of Insurance Supervisors has issued a series of documents describing its plans for prudential regulation of internationally-active insurance companies, building on recent work defining global systemically-important insurers (G-SIIs)[1] and the broader framework of reform initiatives from the Financial Stability Board (FSB) and Basel Committee. The standards include the first risk-based capital rules for insurers akin in some respects to the Basel III rules for banks,[2] restructuring its ongoing effort to create a common regulatory framework (ComFrame) for internationally-active insurance groups (IAIGs). They also include new macroprudential standards for G-SIIs that would likely require restructuring of designated firms into holding companies with carefully-delineated business lines that segregate "traditional" insurance from non-traditional activities (e.g., monoline credit insurance) and non-insurance activities (e.g., securities financing).

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[1] See **INSURANCE33**, *Financial Services Management*, July 25, 2013.

[2] See **CAPITAL173**, *Financial Services Management*, January 7, 2011.

Impact

With the release of all of these documents, the IAIS has fleshed out aspects not only of its planned capital regime for G-SIIs and internationally-active insurers, but also for a broader array of prudential and orderly-resolution standards. These have been laid out in some detail not only in the G-SII standards noted above, but also in a consultative paper from the FSB detailing a systemic-resolution regime for insurance groups.[3] The new documents – principally sets of frequently-asked questions (FAQs) do not differ from these more detailed papers, but build on them to lay out standards IAIS expects shortly also to propose for public consultation. The sum total of these rules will dramatically realign insurance regulation, bringing it closer to the reformed framework developed under the aegis of the Group of Twenty (G-20) heads of state for the financial-services industry.[4] This could well prevent any repeats of AIG-style failures and resulting systemic risk, although at the cost of a new framework that the U.S. insurance industry has protested as inappropriate to the business as they envision it.[5]

Like the broad G-20 framework, the IAIS standards are designed not only to protect overall solvency across the global insurance sector, but also to craft a new systemic regime. As a result, macroprudential standards will be imposed to ensure orderly resolution to achieve the goals cited above. Indeed, one of the IAIS papers stipulates that the primary objective of the macroprudential standards is to ensure orderly resolution. However, it also says that the framework is intended to counter any funding advantages G-SIIs may derive from this status, advantages presumably accorded by the market only if it expected some forms of too-big-to-fail support backing G-SIIs. To the extent the resolution framework in fact cured for TBTF, then any additional cost of the capital rules would essentially tax size or other indicators of G-SII status, a concern parallel to that for the new capital surcharges to be required of global systemically-important banks (G-SIBs).[6]

The capital framework for IAIGs, as well as across the insurance industry, has been the subject of considerable attention in the wake of the financial crisis. IAIS and other regulators have thus developed “Solvency II,” a standard designed to reform current rules that has run into considerable difficulties due to its complexity and obstacles to cross-border implementation (especially in the U.S.). The new IAIS documents do not repudiate Solvency II, but now add to it the concept of a risk-based standard dubbed an insurance capital standard (ICS). The new ICS is “finalized in concept,” but will be further developed, IAIS says. How this is done in practice will have far-reaching implications for the insurance industry, which to date has operated under a capital framework premised principally on the categories of investments (e.g.,

[3] See **INSURANCE34**, *Financial Services Management*, August 19, 2013.

[4] See Client Reports in the **SUMMIT** series.

[5] See **INSURANCE35**, *Financial Services Management*, August 20, 2013.

[6] See **CAPITAL180**, *Financial Services Management*, November 16, 2011.

sovereign bonds) and reinsurance or intra-group guarantees that count as capital. The Solvency II effort sought to make the framework more robust without many attributes of a risk-based framework, but it has so far been difficult to finalize Solvency II. The interaction of this pending standard and the new risk-based one is unclear, as is the ability of national supervisors to concur on a risk-based approach given their hesitancy over Solvency II.

Even if these problems are surmounted, the risk-based insurance framework could be subject to the arbitrage that the Basel Committee is now seeking to address in part through a back-up leverage charge for internationally-active banks.[7] The IAIS does not propose any such sweeping charge – indeed, it does not address the arbitrage issue – although the G-SII higher loss-absorbency requirement is called a “backstop” one that perhaps might be used as a floor on risk-based capital for designated insurers.

The new macroprudential framework for G-SIIs is also to include a liquidity risk-management component. This is not discussed in much detail, although IAIS does say that it should address both baseline and stress scenarios and pay particular heed to liability run-off risk. Current bank rules in this sector include general guidance[8] and specific ratios.[9] The extent to which IAIS plans to model insurance rules on these is unclear, but it seems likely that the IAIS approach will remain less prescriptive for an extended period of time.

The IAIS documents also address internationally-active insurance groups. The ICS is to apply to them, along with additional risk-management requirements in the soon-to-be-finalized ComFrame. Group-wide supervision is a critical part of this framework. However, the extent to which insurance supervisors in the U.S. have authority over a parent company that controls an insurance company is at best uncertain. The Federal Reserve has power over depository holding companies that control an insured depository, although it has yet to decide precisely how to govern them from a capital or broader risk-management perspective. Should the parent of an insurance company be designated as a systemic nonbank financial company by the Financial Stability Oversight Council (done so far for two insurers), then the FRB would also become the parent company’s supervisor. However, absent this, group-wide supervision is difficult under U.S. law. U.S. insurers might thus remain outside the scope of IAIS standards, although this surely will create considerable concern for international insurers, raising questions about fair trade in financial services with regard to insurance.

As noted, all of these new initiatives come in concert with prior IAIS work on Solvency II, ComFrame, and other reform initiatives. Several of the

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[7] See **LEVERAGE3**, *Financial Services Management*, July 22, 2013.

[8] See **LIQUIDITY5**, *Financial Services Management,* January 27, 2010.

[9] See **LIQUIDITY9**, *Financial Services Management*, January 15, 2013.

documents include tables designed to clarify how each initiative relates to all of the others. However, this remains unclear and the extent to which initiatives are duplicative or contradictory unresolved. As a result, the formal consultations on which specific work will be based may need carefully to delineate which rules start and stop where or G-SIIs and internationally-active insurers could be covered by a complex and burdensome regulatory framework, especially when home- and host-country standards applicable to them, their parents, and/or any affiliates are taken into account.

What's Next

The IAIS issued all of these documents on October 9. ComFrame's development is scheduled to end in December of 2013, with field-testing running through 2018. ComFrame, along with the ICS, would then be set for 2019. In 2014, IAIS will also develop loss-absorbency requirements designed to ensure orderly liquidation set for adoption by G-SIIs by late 2014 and for implementation by the end of 2015 (with IAIS not making clear if by "implementation" it means by G-SIIs or if national regulators are to formalize the rules by this deadline). Most, if not all, of these standards will be refined through proposals released for public comment.

The documents also indicate that G-SII measures on enhanced supervision (including development of the Systemic Risk-Management plan and effective resolution should be implemented immediately after the first cohort of G-SIIs is designated. Given that this has already happened, this planning is now required by designated G-SIIs (although the specifics for doing so remain in flux as noted above). Recovery and resolution plans, including liquidity risk-management plans, are to be developed and agreed to by crisis management groups (CMGs) by the end of 2014. The systemic risk-management plan is to be completed within twelve months after designation of future G-SIIs, and then assessed by national authorities within 36 months.

The G-SII standards do not assess reinsurance, which the IAIS intends to do on a separate track. Financial-guaranty insurers are also not addressed – again, this remains under review, as do standards to determine domestic systemically-important insurers, a concept that mirrors Basel rules on domestic systemically-important banks.[10]

Analysis

As noted, these documents are fact sheets and FAQs, not specific proposals. Key points germane to G-SIIs (the macroprudential framework) and to internationally-active insurers (ComFrame) are described below.

[10] See **CAPITAL189**, *Financial Services Management*, October 16, 2012.

A. Prudential Standards

The FAQs on these requirements in large part reiterates key findings and proposals in the IAIS and FSB papers discussed above. Additional points of note include:

- The principal purpose of the macroprudential standards is to ensure resolution without resorting to sovereign support or resulting systemic risk.

- G-SII capital standards will ensure higher loss absorbency across the insurance group, taking into account non-insurance entities. A consultation will determine the scope of entities included in the overall loss-absorbency requirement, which is not only intended to ensure orderly resolution, but also as noted to counteract any funding advantages derived from G-SII status. The standards are also designed to reflect the risk of non-traditional insurance, perhaps varying by the amount of separation between these operations and those of the broader insurance group. Initially, the loss-absorbency requirement will be a backstop charge imposed on its own; it will be recalibrated when the ICS is finalized.

- Group-wide supervisors should require G-SIIs to ensure ample liquidity under both routine and stress scenarios.

- Additional work identifying macroprudential risk across G-SIIs is under way at IAIS and will be addressed in various forthcoming reports.

B. Coverage

As noted, this would apply to internationally-active insurance groups (IAIGs), a definition based on size and international activity subject to national discretion. Specific IAIG criteria would be:

- premiums written in at least three jurisdictions and those written outside a home jurisdiction are more than ten percent of a group's total; and

- assets of more than $50 billion or gross written premiums of more than $10 billion.

C. Standards

As noted, these will include the new ICS. However, group-wide supervision is also contemplated in ComFrame, along with enterprise risk-management standards. IAIS will implement consistent standards to share information and otherwise supervise IAIGs. The group-wide supervision will likely be the one where the "head" of the IAIG is based and most of its operations are housed, as long as the supervisor has the authority to govern the parent company. As noted, this is uncertain in the U.S.