

Creating a common language for regulating global insurers

Insurance Governance Leadership Network

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Insurance Governance Leadership Network ViewPoints



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The great financial crisis brought to a head the growing mismatch between the structures of complex insurers and the remit of their supervisors. Historically, insurance has been largely a domestic affair, with local policyholders protected by local supervisors and solvency regimes; however, in the last several decades, strategy changes and merger and acquisition activity have created numerous international insurance groups. Yet despite this internationalization, many products are still created for specific markets and fully capitalized local subsidiaries are overseen by local supervisors. The crisis revealed that this local supervisory structure did not provide meaningful regulation at the holding-company level, and that non-insurance subsidiaries could create significant harm for companies and the financial system as a whole.

To correct these problems, policymakers have introduced stronger consolidated group supervision and risk management, new solvency regimes, and new regulatory and supervisory authorities and powers, among other changes. According to one insurance executive, *“In some ways, regulatory environments are catching up with the evolution of the industry. Regulation grew out of assumptions that insurance was a local business. The laws were codified to reflect that.”* Today, insurers must be responsive to an increasing number of regulators, each with somewhat unique objectives that are not always aligned.

For supervisors to work together effectively, they must create a common language and standards through which to understand insurers’ vast operations. Developing this common language is an arduous process that, in the words of one director, *“highlights areas where supervisors are not aligned.”* These points of tension come to the fore in discussion of local and global capital standards and recovery and resolution planning. Each of these topics tests ambiguity in the existing regulatory frameworks and requires meaningful consensus within, and across, the public and private sectors.

On March 5, global insurers, along with key policymakers and supervisors, convened in New York to discuss and advance mutual understanding of these challenges. In the process, the group identified additional supervisory priorities that could help foster cross-sector dialogue and improve alignment between public and private sector participants. This *ViewPoints*¹ explores the following themes:

- Numerous initiatives seek to strengthen and unify supervision of global groups
- Capital standards could become the “common language,” but adopting them has proven challenging
- Recovery and resolution planning requires careful design and global harmonization

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- Director

- Despite differences, regulators and insurers agree on a number of issues that can serve as a model for cooperation

Numerous initiatives seek to strengthen and unify supervision of global groups

Regulation has not kept pace with the shape of the industry, harming both insurers and their regulators. Insurers list a number of operational challenges resulting from the highly fragmented regulatory environment. The peculiarities of local product, capital, and reporting requirements have prevented firms from achieving the full benefits of scale, despite insurers' recent merger and acquisition activity. Instead, firms have operated as conglomerates, or the sum of many distinct parts, without realizing synergies. In addition, local capital requirements and rules surrounding capital mobility have led to some units becoming overcapitalized, reducing capital efficiency and increasing complexity and associated costs.

For regulators, fragmented supervision meant an incomplete picture of the risks within the groups, and the possible threats posed to the greater financial system. The disconnection between corporate experience and supervision came to a head in the financial crisis, when the activities of specific subsidiaries threatened the solvency of their larger groups and the health of the financial system. While AIG is the most famous example of this problem, several other insurers required large infusions of public funds to weather the storm.

In response, domestic regulators and multinational supervisory entities are pursuing major initiatives to align supervision across borders in several important ways:

- **Strengthening group supervision.** True supervision at the holding-company level is intended to capture “the full spectrum of [an institution’s] group-wide activities and risks, including all risks from entities within the group (whether regulated or unregulated) that may have a significant impact on the financial position of the group.”² Group supervision includes oversight and rules for group solvency, governance, market conduct, and other group functions.

The challenge for group supervision is that insurance supervisors still operate quite independently, and in the largest markets – North America, Europe, and China – have different approaches to solvency calculations, accounting standards, and expectations for governance. Furthermore, significant variations within the markets, such as among the 50 US states or the countries of the European Union (EU), compound difficulties in reaching consensus on common standards. This challenge can increase exponentially for firms with a truly global footprint. For example, firms like AIG, Prudential Financial, and MetLife have the Federal Reserve as group supervisor, but local subsidiaries receive supervision through individual US states and through dozens of national authorities.

- **Reforming supervisory authorities.** While countries have taken different approaches to strengthening supervision, many have undertaken structural reform within their supervisory authorities. One executive characterized these changes as “*moves to increase the profile of insurance regulation.*” Some stand-alone insurance supervisors merged with banking counterparts, as was the case in France. In the United Kingdom, policymakers moved insurance regulation into the central bank and split prudential and

“The regulatory model has not kept pace with the development of global groups.”
- Director

conduct regulation between two new entities. With respect to the United States, one director observed, *“We’ve seen increasing centralization at the federal level. Authority has gone to banking supervisors and the federal system.”* For more information on the key supervisory authorities, see Appendix 2.

- **Creating a common framework and establishing comparability across regimes.** Given insurers’ drive toward globalization and widespread focus on the supervision of financial institutions, an early hurdle for the global community of supervisors is the establishment of a common framework for regulation and the securing of comparability across diverse regulatory regimes. The International Association of Insurance Supervisors (IAIS) is spearheading this work through several initiatives, which include designating and drafting policy measures for global systemically important insurers (G-SIIs), establishing the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)⁴ and, more recently, creating the first global capital standards for large insurers. Andrew Bailey, deputy governor of the Bank of England, 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.”⁵

“You cannot effectively supervise globally active firms without having a consistent, comparable, quantitative standard.”
- Jaime Caruana, General Manager, Bank for International Settlements³

Capital standards could become the “common language,” but adopting standards has proven challenging

As many insurers and supervisors have noted, resolving the fragmented approach to capital is a necessary first step toward comparability across supervisory regimes. At the global level, the IAIS is spearheading an initiative to create the first global capital standards for the largest insurance groups. In the US, the Federal Reserve and the states, through the National Association of Insurance Commissioners, are now endeavoring to establish domestic group standards. Europe is in the process of implementing the Solvency II Directive, an initiative that took more than 10 years to complete. One of the hallmarks of Solvency II is the establishment of specific minimum and solvency-level capital requirements. In addition to each of these local capital standards, global requirements will be in place by 2019. For more information on the development of US and global capital standards, see Appendix 3.

A variety of obstacles and differing objectives ensure that the process to develop these new standards will not be easy. The challenge is amplified by the urgency and timelines of the current processes. One non-executive director remarked, *“This is Basel [capital standards] for insurance. That makes some sense, but how long have they been working on Basel?”* Participants raised several important questions about the development of capital standards, outlined below.

Can policymakers establish capital standards in the face of conflicting accounting and valuation requirements?

Accounting differences are, perhaps, the single greatest threat to the development of a uniform global standard. Yoshi Kawai, secretary general of the IAIS noted, “It needs to be recognized that our starting point with respect to the valuation of assets and liability is one that lacks global comparability and that sees different valuation principles across jurisdictions.”⁶ While accounting regimes differ around the world, this challenge is most

apparent in the divergence between the Generally Accepted Accounting Principles (GAAP) and statutory accounting of the United States, and the market-consistent valuation approach in Europe. Specifically, as one non-executive director noted, *“Everyone can value assets, but the approach to liabilities is unclear.”* In addition, several critics charge that current European and IAIS proposals set standards predicated on long-term yield curves that are unreliable over time.

Among IGLN participants, two dominant viewpoints on the possible outcomes of the IAIS capital-standards development process emerged:

- **IFRS versus GAAP.** Some participants anticipate IAIS will identify a preferred accounting standard and valuation methodology, widely assumed to be a version of the International Financial Reporting Standards (IFRS). One director spoke for several when he said, *“I don’t see how you settle on a capital standard without agreement in accounting. However, neither side is willing to accept another’s approach.”* Participants also acknowledged that the possibility of any real middle ground between standards was destroyed when, as one executive noted, *“[Those responsible for accounting harmonization] worked on it for years and then they didn’t just leave the field, they declared failure. It couldn’t be done.”* Favoring one valuation approach over another could have significant market effects, including creating winners and losers among both providers and consumers by making some products and business models less viable.

US concerns about volatility and procyclicality

US insurers and many state regulators have been vocal in their opposition to market-consistent valuation. As one chief risk officer noted, *“Market-consistent approaches create volatility that never materializes.”* Some have argued that in weak periods, the results could understate capital and encourage procyclicality, reducing the stabilizing power of insurers as long-term investors and hurting individual bottom lines.

A recent Bank of England report found some evidence of procyclical investment by insurance companies following the dot-com bust and the recent financial crisis.⁷ The report noted, *“It is theoretically possible that regulation of insurance companies – in particular the combination of mark-to-market valuation methods and risk-based capital requirements – might, in some instances, encourage procyclicality.”*⁸

- **Alternative approaches.** Other participants hope for a more accounting-agnostic *“third way.”* Several suggested there could be a way to create a common language without a prescriptive international capital standard. Insurers are keen to explore and understand regulators’ reactions to industry proposals to use economic capital or cash flow analysis models as a basis for comparison across companies in lieu of capital standards. Economic capital is the amount of risk capital that an insurer must maintain to remain solvent at a given confidence level and over a specific time horizon. Economic capital modeling allows insurers to identify and quantify risk exposure explicitly, rather than providing for risks with margins and capital requirements that do

not vary according to the risk profile.⁹ While firms and regulators already regularly rely on economic capital analysis, one regulator observed, *“You can use it to understand risk exposure, but it only shows you a point in time. Economic capital is market based and you can’t really stress test that.”* Accordingly, while economic capital, cash flow, or other analyses provide important perspectives on insurer solvency, whether they could replace minimum standards and provide the same degree of security and comparability remains to be seen.

IGLN participants continue to support the IAIS standards-development process, but one director asked, *“All of these things have uncertain outcomes. What is the Plan B? Say we can’t come to an agreement that works for all jurisdictions? That’s the goal we work toward, but what happens if that can’t work?”* Several directors agreed with one who said, *“We may need to have a common language without a capital standard.”*

Will new requirements cause insurers to make decisions that adversely affect some customers or constituencies?

John Huff, director of the Missouri Department of Insurance, recently noted, *“When [supervisors] talk, debate, and discuss concepts at the IAIS ... we must remember that our decisions may have both positive and negative implications for policyholders in our home markets. Therefore we must be sure to consider the unintended consequences of our work as it develops. Let’s also acknowledge that there are competitive implications as well.”*¹⁰

The new requirements may well alter the way the insurance business model is conceived. As the model evolves, there may be negative impacts:

- **Business model changes may adversely affect customers.** Several directors noted that insurance is a business in which total operating costs form a very high proportion of total revenues. In response to pressures, large insurers have already gone to great lengths to reduce operating costs. Further increases in operating costs, due to either capital requirements or expenses associated with meeting regulatory requirements, will cause further price increases, market exits, and consolidation. One director said, *“You see a flight from capital-intensive businesses and from unprofitable lines and parts of the globe. I think most boards are taking a harder look at how they make money.”* Several insurers have suggested that this sort of discipline is often good for companies but may not always be in the best interest of customers. One director said, *“It can be a very difficult picture. For growth, everyone looks to the developing world, but margins can be razor thin. Can you profitably serve those customers? If they are not served, then do you see less economic growth or stability in those regions?”*

While regulatory capital requirements are just one of several factors putting pressure on insurers’ bottom lines, directors are united in their view that the pressure from these requirements is significant. Current estimates indicate that the basic capital requirement (BCR) will amount to roughly 75% of local capital requirements. However, the IAIS has indicated that the combination of BCR and higher loss absorbency (HLA) will require more capital than G-SIIs currently hold. Accordingly, the capital charges on non-traditional, non-insurance activities (the basis for HLA) will have to be quite significant for G-SIIs and may make those products unprofitable.

“If you pay [HLA] exclusively on [non-traditional and non-insurance] activities, you’re talking about a very large capital requirement for these activities.”

- Andrés Portilla,
Managing Director,
Institute of
International
Finance ¹¹

- **Services and products may migrate to the less regulated shadow financial services sectors.** Several participants suggested that services for less profitable segments won't evaporate but will simply move into the shadows. *"I would expect new capital rules will cause some insurers to rethink [non-traditional and non-insurance activities],"* said one executive. *"But if we stop doing it, it doesn't mean it goes away. A less regulated entity will probably take it up if there is a market need."* A recent Financial Stability Board monitoring exercise found that non-bank financial intermediation assets grew in 2013 by about 7%, to \$75 trillion; globally, those assets represent approximately 25% of total financial assets.¹²
- **Higher capital could reduce the industry's appetite for long-term assets.** While most comments focused on changes that would affect consumers, one supervisor noted, *"Increased capital charges could reduce long-term investment, with important consequences."* In addition to the anticyclical effects of such investment, this could mean a material reduction in investment in infrastructure and similar asset classes. In recent Solvency II debates, numerous policymakers have acknowledged the importance of the sector's investment in long-term assets, including projects such as roads and healthcare centers. These investments serve as an important source of financing for projects that benefit the public and fulfill broader public policy objectives.

"Increased capital charges could reduce long-term investment, with important consequences."
- Supervisor

Will political and legal realities preclude adoption of a single, global standard?

A number of different policy objectives, political realities, and legal constraints may make it difficult to adopt one uniform standard. Participants identified the following challenges:

- **Policymakers and supervisors have different primary objectives.** Within the US context, the Federal Reserve is charged with ensuring financial stability while the states are more concerned with consumer protection, affordability and, by extension, individual firm solvency. Efforts to promote greater stability could be at odds with some consumer interests.
- **Key actors in the US and Europe appear to be moving apart.** Some US regulators and politicians have balked at the prospect of an IFRS-based standard. They have also noted that adoption of a global standard within the United States requires the assent of at least 42 state legislatures, many of which are unlikely to support such a standard. At the same time, after more than a decade of Solvency II development, several European regulators have indicated that any global standard should conform with Solvency II.

Understanding the interaction of global and US-domestic capital developments

Many industry participants questioned how the Federal Reserve capital-standards development process may influence the global process, or vice versa.

The Fed, which acts as group supervisor to insurers designated as non-bank systemically important financial institutions (SIFIs) as well as those that have a savings and loan holding company within the group, is currently developing a capital standard for the 15 to 20 insurers under its supervision. The Fed estimates that these insurers account for one-third of industry assets.¹³

Federal Reserve Governor Daniel Tarullo is leading the development of the capital standards, and is also the chairman of the Financial Stability Board's standing committee on supervisory and regulatory cooperation. Given Governor Tarullo's role in US and international processes, participants were curious if the Fed would adopt IAIS international standards or, alternately, if a domestic standard could drive and influence development of international insurance capital standard.

While the group did not reach consensus on this question, several participants believed the Fed would push forward a strong domestic standard that works well in the United States, and seek to encourage the international process to move toward common ground. This option could allay domestic political concerns and help assure the United States' ongoing participation in the global process.

Do current standards-development processes adequately consider the experience of the insurance industry?

Throughout the post-crisis period, insurers have raised concerns about the application of bank-like standards to insurers. Supervisors like the Fed, who generally lack insurance expertise, have responded by hiring individuals with extensive sectoral knowledge and have increased engagement with firms and industry groups. Recently, insurers have moved beyond the early notion that insurers are not like banks, and begun to more clearly articulate areas of concern. One director acknowledged, *"There are fundamental differences, and we have not always been good at explaining those. We need to be better so the rules don't do more harm than good."*

Many participants agreed that the industry should work alongside regulators to ensure rules function to accomplish the desired objectives. Participants identified the following areas where new regulation should carefully consider industry dynamics and experience:

- **Banks and insurers face different risks, even for similar assets.** One executive said, *"One thing I still don't see real recognition of is that you don't have cash outflows at will [in insurance]."* Another executive agreed: *"If a bank and an insurer are holding the same bond, it does not present the same risk because the purpose and duration of the asset are different."*
- **Industry default experience should inform new standards.** Participants acknowledged that new tools are needed to protect against contagion within the

financial system that might arise from problems within an insurer or insurers. However, several directors noted that it is important to consider the history of insurer defaults in order to understand how problems can occur, as well as the likelihood of occurrence in a large insurance group. One director observed, *“There are three important factors. First, the rate of default – it is low. Second, the loss from defaults has been minimal. Third, those who default are most often monolines; they are not diversified.”* Participants agreed that new capital or recovery and resolution planning requirements should be responsive to the fact that historical regulatory practices and standards have generally worked well.

- **Bolstering capital is a blunt tool; other tools are also available.** One director said, *“My concern is that you will have to hold more capital until you can prove you don’t need it, and you can’t prove a negative.”* Another agreed, noting, *“Banks are now holding more than twice their previous levels of capital. Is that a standard that could be applied to insurers?”* Furthermore, some problems defy better capitalization. *“No level of capital would have helped AIG,”* said one director. Some challenges may also be a function of liquidity constraints. One director suggested the industry should push regulators to be more specific about required levels of assets and liabilities, as well as where it is acceptable to have asset-liability mismatches: *“Regulators could say what they want and don’t want ... The problems occur when you get wrong footed on both sides of the balance sheet – assets and liabilities ... You can’t hold one for one or there is no business. So the question becomes, which mismatches are permissible?”* Several participants agreed that across-the-board requirements for higher capital effectively amount to regulating insurers’ return on capital.
- **Capital rules should include discussions of mobility as well as absolute standards.** Capital mobility or fungibility is an essential part of the discussion of a group’s capital position, but some non-executives fear it is being overlooked in an effort to create strict quantitative standards. *“It is not just how much capital you have, but [whether you can] get it to the right place when you need it,”* said one director. Several participants suggested that lower standards, coupled with greater mobility, would help to maximize regulatory and industry goals. At the same time, insurers fear that the kind of mobility present in the past, such as after events like 9/11, no longer exists. According to one executive, *“The real danger is trapped capital at the holding-company level that cannot be deployed to help subsidiaries or policyholders. That kind of restriction would prevent the greatest good to the greatest number of people.”* For some supervisors introducing additional complexity, such as fungibility measures, would make governance and supervision more difficult. One supervisor said, *“Introducing additional complications of fungibility into models will make them worse. Insurance companies usually go belly up based on reserve flows or asset problems. It is harder to point to liquidity as the problem. We can stress test fungibility and get important signals; making it a part of models would make them harder to use.”*
- **Credit rating agencies, not authorities, may prove to be the golden standard.** One director said, *“Let’s not forget, the rating agencies can be the highest bar and the binding constraint.”* For the largest insurers, credit ratings may drive capitalization more than regulatory requirements because, according to one non-executive director, *“We*

“There is a focus on some absolute number for capital, but this is also about liquidity. Is the capital in the right place or can we get it to where it needs to be?”

- Director

cannot risk the downgrade because of the domino effect and how it could cascade through the business.” For some groups in some solvency regimes, the rating agency standard becomes the target, and regulatory capital may be more of a minimum standard.

Recovery and resolution planning requires careful design and global harmonization

G-SIIs are required by group supervisors, in coordination with the IAIS, to develop recovery and resolution plans, and a growing number of large insurers also face domestic requirements. G-SIIs were required to develop these plans already, prior to receiving much formal regulatory guidance. To further complicate the issue for G-SIIs, US regulators, including the FDIC and the Fed, rejected the first plans submitted by many large banks. These rejections raised important questions about plan assumptions and their construction. Furthermore, while subsidiary resolution and guaranty frameworks for insurers abound, some nations have yet to create a legal framework for group resolution. As these legal frameworks evolve, industry participants raise important issues.

Planning should focus on recovery, not resolution

“Recovery is the thing you do so you don’t have to do resolution,” said one director, *“but the regulatory focus is mostly on resolution.”* Recovery and resolution are two very different processes and, according to regulators and insurers, there should be more attention on recovery. One regulator said, *“The recovery exercise has been hugely educational. It demonstrates the improbability of resolution and how to prevent it.”* Another regulator agreed, saying, *“As we split our time, much more attention should be paid to recovery. There is too much focus on resolution.”*

Traditional banking resolution frameworks will harm insurers and policyholders

One director warned, *“The FDIC will go into an insurer on a Friday night, separate assets and liabilities, and liquidate immediately. That doesn’t work in insurance because you sell at the bottom of the market, long before liabilities turn into a cash demand.”* Another agreed: *“The FDIC will flunk you and your plan if you cannot be resolved in a weekend.”* However, several participants noted that the amount of money recovered by policyholders through past resolution processes – some of which lasted decades – coupled with the relatively small number of resolutions, suggests that the existing approaches will continue to be appropriate for the industry in the future.

“If the obligation in resolution is ‘first do no harm,’ then you don’t want a speedy framework.”
- Risk chair

Despite differences, regulators and insurers agree on a number of issues that can serve as a model for cooperation

Over the dinner discussion, participants identified several areas where regulators and insurers have common goals, if not a common language, and can make joint progress:

- **Supervisory colleges.** Supervisory colleges are growing in volume and sophistication, becoming an increasingly important forum. Regulators defined their value both in terms of information exchange and the development of relationships and trust among supervisors. Colleges provide essential frameworks to help foster understanding of different cultures, legal and regulatory frameworks, and information-sharing

requirements. According to one regulator, *“We need them to help develop relationships with other regulators in advance of problems. We need to have a mutual understanding so we are not testing each other in a crisis.”* Insurers agreed that colleges are becoming much more useful and, in some cases, moving beyond pure information sharing.

- **Hiring.** Authorities are hiring insurance talent in policy and supervisory positions. One regulator said, *“I’ve observed a lot more eagerness to do this right. We have hired people who know the insurance business. We continue to do so.”* Industry and regulatory participants agreed that authorities that are new to insurance need to aggressively recruit appropriate talent.
- **Cybersecurity.** Participants widely agreed with one regulator who said, *“Cybersecurity may be an important uniter.”* The supervisors in the room did not see themselves as leading on the issue of cybersecurity, but they are increasingly concerned about it and the resilience of organizations. One regulator said, *“Everyone is motivated by fear to get better at this ... We have a role to play in the cybersecurity challenge, but that role is still in development.”* Insurers and regulators expressed an interest in working together to understand and address this growing challenge. Furthermore, one supervisor suggested, *“Successful work on cyber could provide a model for broader cooperation between insurers, supervisors, and government.”*
- **Board review packets.** Directors and regulators were united in their belief that board packets are too large, raising questions about how much board members can absorb and oversee. One regulator observed, *“Our focus is on governance. Do boards have a sufficient understanding of the business and the risks? ... If packets get in the way of governance, that is a concern.”* The volume of material and required time commitment continue to increase, even though some believe we are in a post-crisis period. Others assert that prolonged volatility, uncertainty, complexity, and ambiguity mean board responsibilities will continue to intensify. Above and beyond boards’ own concerns about their time, shareholder and proxy firms are increasingly weighing in on the value of individual directors based on perceived levels of engagement.

One partial solution may be for management to be more assertive in editing board material, rather than simply providing large volumes directly to the board. Similarly, directors recognized the need for management to rehearse material before board meetings, but they also want direct and open communication. *“Anything we can do to get to less presentation and more discussion would be a good thing,”* said one director.

Fortunately, insurers report that despite these challenges, their boards are not experiencing trouble recruiting top talent. *“The job is becoming more substantive, so the candidate pool has gotten better. It draws intellectually curious individuals,”* one director said.

Within the next several months, domestic regulators and the IAIS are scheduled to make significant progress on the development of capital standards. In some ways this is a grand experiment, and one on a very short timeline. One director said, *“If or when these*

different standards come to pass, no one will be completely happy. There will be lots of compromises.” However, among industry observers there is a real question as to whether key stakeholders will be willing to compromise and to what degree. In the absence of a set of universal standards, insurers and regulators will need to determine how to live with continued divergence. Both outcomes – universal standards or continued divergence – will require insurers and supervisors to work more collectively in order to optimize results.

We hope that the IGLN can continue to serve as a useful forum to improve understanding on these important topics.

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, senior management, advisers, and stakeholders who become engaged in this leading-edge dialogue, the more value will be created for all.

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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 multistakeholder 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.

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EY is a global leader in assurance, tax, transaction, and advisory services to the insurance 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

AIG

- Peter R. Fisher, Non-executive Director, Senior Fellow, Tuck School of Business at Dartmouth College
- John Fitzpatrick, Risk and Capital Committee Chair and Audit Committee Member
- Daniel Rabinowitz, Global Head of Regulatory Capital Policy
- Doug Steenland, Regulatory, Compliance, and Public Policy Committee Chair and Risk and Capital Committee Member

Aon

- Mike Losh, Audit Committee Chair

Evercore

- Tom Leonardi, Senior Advisor, Former Insurance Commissioner of Connecticut

Federal Reserve (New York)

- Sarah Dahlgren, Executive Vice President, Financial Institution Supervision Group

MetLife

- Stan Talbi, Executive Vice President, Global Risk Management and Chief Risk Officer

Missouri Department of Insurance, Financial Institutions and Professional Regulation

- John Huff, Director, NAIC President Elect

Office of the Superintendent of Financial Institutions

- Jim Doherty, Senior Director, Life Insurance Group

Sompo Japan Nipponkoa Holdings

- Jan Carendi, Senior Advisor to CEO

EY

- John Latham, Global Client Service Partner
- Keith Ender, Global Client Service Partner
- Rick Marx, Principal, Business Advisory and Risk Management Services, Insurance

Tapestry Networks

- Leah Daly, Principal
- Jonathan Day, Vice Chairman
- Colin Erhardt, Associate
- Peter A. Fisher, Partner

Appendix 2: Key supervisory authorities

In the North American and global contexts, several important authorities are leading the development of new regulations for the largest insurance groups:

- **International Association of Insurance Supervisors (IAIS).** Established in 1994, the IAIS is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions.¹⁴ The IAIS issues global insurance principles, standards and guidance; provides supervisory training and support; and organizes meetings and seminars for insurance supervisors.
- **European Insurance and Occupational Pensions Authority (EIOPA).** EIOPA is a financial regulatory institution composed of representatives from the insurance and occupational pensions supervisory authorities of the European Union. It was created following the financial crisis to help ensure a more level playing field across the EU and to reflect the increasingly integrated financial markets. EIOPA carries out a number of significant functions, including strengthening supervisory colleges and enhancing the prudential regime within the EU through the drafting and oversight of the Solvency II Directive.
- **Federal Insurance Office (FIO).** The Dodd-Frank Wall Street Reform and Consumer Protection Act established the FIO in the US Treasury. Given the long-held preference for state regulation, the FIO is not a supervisor but is authorized to monitor the insurance sector and represent the United States on prudential aspects of international insurance matters. The FIO is a member of the IAIS's executive committee.
- **Federal Reserve (Fed).** Dodd-Frank authorized the Fed to supervise insurers that are designated as non-bank SIFIs, as well as those entities that have savings and loan holding companies within the insurance group. As a result, several large US-based insurers now have the Fed as their consolidated supervisor. The groups that are supervised by the Fed hold approximately one-third of industry assets.¹⁵ In addition, Fed Governor Daniel Tarullo chairs the Financial Stability Board's Standing Committee on Supervisory Regulation and Cooperation, the committee charged with insurance oversight.
- **Financial Stability and Oversight Council (FSOC).** Created by Dodd-Frank, the FSOC is charged with identifying and responding to risks to US financial stability. The FSOC is responsible for designating insurers as domestic SIFIs. These SIFIs will be subject to a variety of enhanced prudential and supervisory requirements.
- **National Association of Insurance Commissioners (NAIC).** The NAIC authors standards, coordinates supervision across the states, and accredits state insurance departments. It has been increasingly active nationally and internationally, particularly with the creation of the Solvency Modernization Initiative and with its ongoing participation in IAIS committees.
- **Office of the Superintendent of Financial Institutions (OSFI).** OSFI is an authority that reports to the Canadian Minister of Finance. It regulates banks and is the primary regulator of insurance companies, trust companies, loan companies, and pension plans in Canada.

Appendix 3: US and global capital standards

There are two active processes under way to develop capital standards within the United States:

- **NAIC.** The NAIC has convened a working group to establish a group capital methodology that would apply to US-domiciled, internationally active insurance groups that are under the jurisdiction of individual states. This new group standard will reflect the current risk-based capital approach taken within the United States. In late 2014, the NAIC was considering several kinds of approaches to capital, including a risk-based capital approach similar to existing state requirements, an aggregated entity approach that would set capital requirements for all legal entities, and a cash flow approach that would apply stress tests to internal cash flow models to determine whether sufficient cash flow is available to meet all obligations. The cash flow approach could include a variety of stress factors, such as macroeconomic events and challenges, catastrophic events, or unexpected changes in longevity. Proponents argue that this approach is not dependent on a single accounting regime and could help avoid jurisdictional accounting differences.
- **Federal Reserve.** Like the NAIC, the Fed is in the process of developing capital standards for insurance SIFIs and for those groups with banks that fall within its purview. Recent legislative changes to the Collins Amendment clarified that the Fed is not required to apply the bank-based risk and leverage capital requirements to insurers. In addition, insurers will not be required to prepare financial statements in accordance with GAAP if they prepare statements according to statutory accounting principles at the state level. A number of industry groups have recently presented a cash flow model to the Fed for consideration. It is not clear when the Fed will establish these standards; however, it seems likely that, whatever capital standards the Fed requires, they could have significant monetary implications for individual firms and for the industry. The Fed, FIO, and NAIC are in consultation throughout the development of these standards. The so-called “Team USA”¹⁶ approach seeks to present a unified view within the United States and in external venues such as IAIS.

The IAIS is developing three capital standards for internationally active insurance groups. Each one will be submitted for consultation and field tested prior to implementation. All will be developed by 2016 and take effect in 2019:

- **Basic capital requirement (BCR).** The BCR was completed in 2014 and creates a comparable capital baseline for the application of higher loss-absorbency requirements for the nine G-SIIs. The BCR applies to the insurer’s entire book of business, including all group structures and financial and material non-financial activities. It is composed of 15 factors and makes use of a market-adjusted valuation.¹⁷ Initial field testing revealed that, on average, the BCR calls for about 75% of local prescribed capital requirements, suggesting that the BCR alone will not require these insurers to increase capital at the mean of the distribution.¹⁸
- **Higher loss absorbency (HLA).** HLA standards are under development and scheduled to be completed by the end of 2015. According to one policymaker, “*HLA sits on top of the [basic capital] requirements, and the focus is just non-traditional and*

non-insurance activities.” Beginning in 2019, G-SIIs will be required to maintain capital at the level of the BCR plus HLA. The key question for G-SIIs is whether the HLA will require insurers to hold additional capital. Many in the industry, as well as several regulators, seem to agree with one executive who said, *“Any global standard has to be more stringent than the most stringent existing standard. Otherwise, what is the point?”* However, given the current requirements of the BCR, simple math demonstrates that HLA would have to be quite large on non-traditional business in order to require higher levels of capital. Alternatively, the HLA may apply to a base broader than the area of focus on non-traditional, non-insurance activities.

“In order to make HLA meaningful, it will have to be very large on top of BCR. It is hard to get to a higher level of capital with HLA.”
- Policymaker

- **Insurance capital standard (ICS).** By December 2016, the IAIS aims to have completed the ICS, though it will be subject to additional refinement. The standard will apply to groups subject to ComFrame, or approximately the 50 largest global insurers.¹⁹ When the ICS is finalized, it will supplant the BCR as the foundation for the HLA standard. Judging from the preliminary consultation, the ICS appears poised to use a market-consistent, more Solvency II-like, approach to valuation. However, it is important to note that as proposed, the ICS is not consistent with Solvency II or with the valuation regimes in the United States and Canada. For North American producers, market-consistent valuation could be unattractive and result in the need to re-price popular long-term products or exit these product markets entirely. As a result, these products may become less popular or may not be available for selected customer segments and geographic markets.

Endnotes

- ¹ *Viewpoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments made during conversations with participants are not attributed to individuals or organizations. This document is based on pre-meeting conversations with invitees and other stakeholders. These conversations were supplemented by an extensive research effort that included interviews with chief risk officers from major global insurers as well as risk chairs and committee members, leading regulators and subject matter experts. Quotes in italics are drawn directly from conversations with participants.
- ² Basel Committee on Banking Supervision, Joint Forum, *Principles for the Supervision of Financial Conglomerates* (Basel: Bank for International Settlements, 2012), 1-2.
- ³ Jaime Caruana, "[Insurance and Financial Stability: A Basel View](#)" (speech, International Association of Insurance Supervisors, Bottingen, Switzerland, March 20, 2013).
- ⁴ For more information on ComFrame, see International Association of Insurance Supervisors, *Common Framework for the Supervision of Internationally Active Insurance Groups, Revised Draft* (International Association of Insurance Supervisors, September 2014).
- ⁵ Andrew Bailey, "[Meeting the Challenges of a Changing World – the View from the PRA.](#)" (speech, Association of British Insurers Biennial Conference, London, July 9, 2013), 7.
- ⁶ Louie Woodall, "[Industry Picks Holes in BCR Proposals.](#)" *Insurance Risk*, October 3, 2014.
- ⁷ Bank of England and Procyclicality Working Group, *Procyclicality and Structural Trends in Investment Allocation by Insurance Companies and Pension Funds: A Discussion Paper* (London: Bank of England, 2014), 21–32.
- ⁸ *Ibid.*, 24.
- ⁹ Economic capital supports business decisions by assessing risk in terms of capital over a time period. In contrast, regulatory capital sets capital requirements for all risks according to specific regulatory rules and guidance. Regulators are using economic capital analysis to monitor Solvency II, and it forms an important part of the US and EU own risk and solvency assessments.
- ¹⁰ John M. Huff, "[Prepared Remarks – Keynote Address](#)" (IAIS Annual General Meeting, October 24, 2014).
- ¹¹ Louie Woodall, "[Experts Call for Changes to First Global Insurance Capital Standard.](#)" *Insurance Risk*, October 30, 2014.
- ¹² Financial Stability Board, *Global Shadow Banking Monitoring Report 2014* (Basel: Financial Stability Board, 2014), 2–3.
- ¹³ Thomas Sullivan, "[International Insurance Regulation.](#)" (testimony before the Subcommittee on Housing and Insurance, Committee on Financial Services, U.S. House of Representatives, Washington, DC, 18 November 2014).
- ¹⁴ IAIS, "[About the IAIS.](#)" accessed April 1, 2015.
- ¹⁵ Thomas Sullivan, "[International Insurance Regulation.](#)"
- ¹⁶ *Ibid.*
- ¹⁷ The valuation is made based on the amounts reported on an insurer's audited, consolidated, general-purpose balance sheets, with adjustments, as specified by the IAIS, to achieve comparability.
- ¹⁸ International Association of Insurance Supervisors, *Basic Capital Requirements for Global Systemically Important Insurers* (Basel: International Association of Insurance Supervisors, 2014), 21.
- ¹⁹ Internationally active insurance groups will be designated by national authorities but will be required to 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 the insurer must have total assets of not less than \$50 billion or gross written premiums of not less than \$10 billion. See International Association of Insurance Supervisors, *Common Framework for the Supervision of Internationally Active Insurance Groups, Revised Draft, 2.*