CLIENT UPDATE

HIGHLIGHTS FROM THE 21ST ANNUAL IAIS CONFERENCE, AND THEIR IMPLICATIONS

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The International Association of Insurance Supervisors (the "IAIS") held its annual conference in Amsterdam October 20-25, 2014. Given the increasing integration of the financial services regulatory framework, particularly for the largest insurers, a group of Debevoise & Plimpton LLP insurance and banking attorneys from the London and New York offices attended the conference. For an interactive discussion of the important topics raised at this year's conference, please attend our seminar in New York this Friday, October 31, either in person or via webinar. Registration is available here.

This summary covers highlights and implications of the conference, including the adoption of final Basic Capital Requirements ("BCR") for Global Systemically Important Insurers ("G-SIIs"), a key first step towards the development of a suite of capital standards that will apply to large insurers globally. The conference also featured panel discussions about resolution planning now being undertaken by G-SIIs; group-wide supervision and governance; and insurance in emerging markets.

REGULATORY CAPITAL

The IAIS published the final BCR on October 23 (a copy can be found here), which the Financial Stability Board (the "FSB") is expected to endorse at the November 2014 meeting of the G20 in Brisbane, Australia. G-SIIs will be required to begin reporting their regulatory capital as calculated under the BCR on a confidential basis to supervisors in 2015.

The BCR largely follows the proposal outlined by the IAIS in its July 2014 consultation paper. Some changes were made to the factors applied to various liability segments, as well as the capital charge on assets under management. Following field testing of the proposed BCR with G-SIIs and some other insurers, the level of the BCR has been set to fall between the upper and lower thresholds for regulatory supervision under Solvency II. The IAIS believes that at this level frequent breaches of the BCR should not occur "assuming normal business conditions", although the final level of capital requirements will not be known until the level of "Higher Loss Absorbency" requirements – which will be added to the BCR for G-SIIs – is finalized, which is expected to happen by the end of next year.

The final BCR framework classifies qualifying capital as either "core" or "additional". Importantly for U.S. insurers, the BCR adopts the proposed requirement that core capital consist of undated financial instruments, thereby effectively excluding financial instruments with a specified maturity, including surplus notes.

The BCR is the first in a series of proposed new capital standards that are intended to apply to large insurers globally. One of these requirements, a global group-wide Insurance Capital Standard ("ICS") that is due to be completed by the end of 2016, has prompted concern among industry participants and some regulators about the speed of these significant developments, as well as the overall structure – with the latter concern focused on the appropriateness of setting capital requirements based on the market value of both assets and liabilities, and the volatility that may cause.

RESOLUTION PLANNING

Regulators and industry representatives on the Recovery and Resolution panel discussed several elements of the resolution plans to be required of the nine G-SIIs, and which are likely, ultimately, to be extended to Internationally Active Insurance Groups ("IAIGs"). The FSB has published the general framework for these plans and this month provided updates focused on insurers.

Regulators on the panel recognized that insurers are different than banks but warned that those differences "should not be overstated", and thus lessons from the bank framework are relevant to pending insurer plans. The G-SII plans will be prepared at a group level, although filers also will need to devote significant attention to the resolution of underlying insurance entities. Panelists also emphasized that the insurance resolution planning process will be a "learning curve" for both the industry and the regulators, and that they expect annual plans to be refined and improved during the first 3-5 years after the initial plan is filed. The panelists cited the first resolution plans filed by the U.S. insurer non-bank systemically important financial institutions, AIG and Prudential, as informative models for both process and content. Debevoise assisted AIG in the preparation of its resolution plan.

Participants noted that, except in a few jurisdictions (notably the U.S.), the IAIS initiative to require recovery and resolution plans is not currently part of local law. However, it is likely that at least some jurisdictions will formally adopt the requirement and extend it to a larger class of insurers, for instance, through a directive in the European Union.

GROUP-WIDE SUPERVISION AND GOVERNANCE

Discussions of IAIS initiatives for group-wide supervision and governance of G-SIIs and IAIGs focused on failures of governance as a key cause of the financial crisis and on the need for regulatory supervision and internal governance to take account of the risk culture of the particular company. There is a renewed focus on corporate governance at both group and individual entity levels by the International Monetary Fund (the "IMF"), the G20 and the FSB, including in the FSB's guidance on supervisory interaction with financial institutions on risk culture, "A Framework for Assessing Risk Culture", published in April 2014.

Panelists drew particular attention to the need for strong board membership at both the parent and individual subsidiary level, for the building of a culture of ethical conduct through example at the most senior levels and for aligning incentives with behavior. Regulatory community commentators called for greater supervisory powers at the parent entity level, including access to the parent's board, access to and inspection of the parent's records and the power to conduct on-site supervisory visits at the parent level. An IMF spokesperson cited the conclusion of a recent IMF report that the lack of a group-wide supervisory framework in many jurisdictions represents a significant shortcoming in potential supervisory effectiveness.

EMERGING MARKETS

The conference also highlighted emerging market issues, with a panel on financial inclusion, or low-income access to insurance, and the prominent presence of Ping An, the Chinese insurer and major conference sponsor (and a designated G-SII). Panelists emphasized the importance of educating consumers on insurance matters and strengthening insurance supervision in emerging markets. They also discussed insurers' efforts to improve access to insurance by, for example, rethinking developed world distribution mechanisms that may not work well in emerging economies. Emerging markets issues also arose in other contexts, including during a panel on capital, where commentators noted that a global capital standard could help established insurers looking to expand in emerging markets through consistent capital requirements.

IMPLICATIONS

While the specific implications for each firm only can be determined with individual discussions, certain key themes learned from the experience with the banking sector (where similar changes occurred 3-5 years ago) likely will apply to all. As group-wide capital rules come into force, insurers will need to re-evaluate their businesses and reduce or eliminate those lines that are no longer viable. Capital elements will have to be reviewed for compliance with the new requirements (*e.g.*, surplus notes may no longer count as core capital), possibly requiring new capital issuances, in complying form, to eliminate deficits. Resolution planning also will push insurers to simplify their structures, and consolidate or dispose of more complex businesses. Governance changes will force more enterprise-wide evaluation of risk, and may influence decisions about allocation of capital and business focus accordingly.

More generally, all of the above factors, as well as others, will interplay with each other, and those organizations that undertake a holistic review of their businesses and objectives in light of these and other changes will be in the best position to succeed in the new financial services landscape. Moreover, again drawing on learning from the banking experience, while the regulators may allow transition periods for this review and implementation, the markets are likely to require compliance with these emerging standards much more quickly.

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Debevoise attorneys Ethan T. James, Thomas M. Kelly, Gregory J. Lyons, Samuel E. Proctor, James C. Scoville and Edite Ligere attended the conference. Please do not hesitate to contact any of them or the other Debevoise contacts listed on the cover page with any questions.

October 27, 2014