Client Update
Significant New International Capital Requirements Announced for Global Insurers, with Potential Impact on M&A Activity

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INTRODUCTION

On October 5, 2015, the International Association of Insurance Supervisors ("IAIS") announced it has concluded its initial development of the Higher Loss Absorbency ("HLA") requirement for Global Systemically Important Insurers ("G-SIIs").[1] The HLA, which is likely to be implemented in 2019/2020, is expected to increase the amount of regulatory capital a G-SII must hold by approximately 10% on average. The precise extent of additional capital required to be held by G-SIIs will depend on the business mix of the particular G-SII and how risky supervisors deem those activities to be. For example, variable annuities and mortgages, where results can fluctuate with changes in financial markets, will attract higher capital charges.

The HLA builds on the Basic Capital Requirement ("BCR"), which was announced by the IAIS in October 2014 and addresses additional capital requirements for G-SIIs which reflect their systemic importance in the international financial system.[2] The IAIS intends to replace the BCR as the

1 At present, there are nine G-SIIs: Allianz SE; American International Group Inc; Assicurazioni Generali S.p.A.; Aviva plc; AXA S.A.; Metlife, Inc.; Ping An Insurance (Group) Company of China, Ltd.; Prudential Financial, Inc.; and Prudential plc. The IAIS is expected to consult on the criteria for G-SII designation in November 2015.

2 For a detailed discussion on the development the BCR and the HLA please see our previous client updates:

http://www.debevoise.com/~/media/files/insights/publications/2015/07/07102015_iais_begins_public_consultation.pdf

http://www.debevoise.com/~/media/files/insights/publications/2015/01/iais%20ics%20issues%20consultation%20on%20global%20insurance.pdf foundation for the HLA with the Insurance Capital Standard ("ICS"), expected to be developed by 2019/2020.

The HLA announcement comes at a time of increasing regional regulatory capital requirements, both in Europe under the Solvency II regime, which will come into force in January 2016, and in the U.S. under the regulatory capital standards currently being developed by the U.S. Federal Reserve Board. It is expected that the new HLA capital standards, along with the Solvency II regime in Europe, will drive M&A opportunities in the insurance sector for all participants as G-SIIs realign their capital structures.

HLA MAIN INGREDIENTS

The HLA is designed to reduce the probability and impact on the financial system of the distress or failure of a G-SII. When the HLA is implemented in 2019/2020, all G-SIIs will be expected to hold regulatory capital that is not less than the sum of the required capital amounts from the BCR and the HLA. The HLA will apply to all group activities, including non-insurance subsidiaries.

The construction process for the HLA takes a "bucket" and "factor" approach, with G-SIIs allocated to one of three buckets based on the risk analysis set out in the G-SII assessment methodology, and with separate factors identified for traditional insurance, assets and, importantly, non-traditional insurance and non-insurance ("NTNI") activities.

A G-SII's HLA capital charge will increase as the bucket level increases, and will be higher for NTNI activities within each bucket than for traditional insurance. Currently there are no G-SIIs expected to be in the highest "bucket" — which the IAIS hopes will serve to discourage insurers from engaging in activities that would put them at that level. Similarly, the higher levels of capital required for NTNI activities are explicitly designed to discourage those activities. At present, there is no clear definition of NTNI activities which carry the largest surcharges, although the IAIS has announced that it will consult on the definition of NTNI in November 2015.

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http://www.debevoise.com/~/media/files/publications/2014/10/20141031a%20%20global%20insurance%20developmens%20following%20iais%2021st%20annual%20conference.pdf

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The IAIS estimates that the HLA required capital for the current set of G-SIIs will average approximately 10% of the BCR (as uplifted to reflect current prescribed capital requirements), with a range from 6% to approximately 19% for the populated buckets.

Capital resources supporting the HLA capital requirement will be required to be of the highest quality. The definition of capital supporting the HLA is the same as previously announced for the BCR, with some slight changes.

The HLA is expected to be privately reported by G-SIIs to group supervisors in 2016. This is in addition to the private reporting of the BCR to group supervisors, which commenced earlier this year.

STRATEGIC OPPORTUNITIES

As G-SIIs and industry participants digest the new HLA rules, we expect G-SIIs to critically review their businesses and the capital needed to support them, which could create downstream strategic opportunities.

G-SIIs may look to divest non-core and NTNI business in order to reduce capital requirements and also to limit their connection to the financial system. This is expected to drive downstream strategic M&A opportunities for all participants in the insurance sector, and non-G-SII firms and other financial investors may be particularly well positioned to buy these assets.

IAIS'S DEVELOPMENT OF GLOBAL CAPITAL STANDARDS

The HLA is the second component in the IAIS's project to develop global group capital standards. The first component was the BCR and the third the ICS. The first version of the ICS is expected to be completed by the middle of 2017 and apply to a larger number of "Internationally Active Insurance Groups" ("IAIGs") from 2020 after refinement and final calibration in 2018/2019. All G SIIs are considered to be IAIGs for the purpose of ICS.

REACTION FROM G SIIS

The initial reaction from the majority of the G-SIIs to the HLA requirement has not been favourable. Some G-SIIs have described the HLA requirement as misconceived and miscalibrated, arguing that the HLA requirement is targeted too widely and has the potential to magnify market downturns. In a joint submission to the IAIS, eight of the nine currently designated G-SIIs (excluding AIG, which submitted its own individual response) expressed the view that the proposed calibration of the HLA was set too high and was unlikely to contribute to financial stability. In particular, the submission argues that the HLA requirement fails to adequately differentiate insurers from banks given that the nature of a G-SII's business model is far less risky than that of a global systemically important bank. The joint submission describes the HLA requirement as a "blunt instrument" which "could lead to unintended effects and pro cyclicality".

CONCLUSION

The impact of the HLA requirement for G-SIIs, when combined with the implementation of Solvency II in Europe and the evolving capital standards currently being developed by the U.S. Federal Reserve Board, is likely to lead to a significant increase in the regulatory capital requirements of global insurers. This, in turn, is likely to translate into increased restructuring and M&A activity.

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Please do not hesitate to contact us with any questions.