IAIS Adopts Global Supervision Framework

November 18, 2019

On 14 November 2019, at its annual meeting, the International Association of Insurance Supervisors (the **IAIS**) adopted a set of comprehensive global frameworks for the supervision of internationally active insurance groups (**IAIGs**), the approximately 70 largest insurers with global activities, and the mitigation of systemic risk in the insurance sector. The adoption of the framework is a key milestone in the international response to reducing systemic insurance risk following the financial crisis.

The frameworks consist of the following three parts:

- the Common Framework (**ComFrame**), which establishes supervisory minimum standards and guidance for the group-wide supervision of IAIGs;
- the Insurance Capital Standard Version 2.0 (**ICS**), which will be part of ComFrame and apply to IAIGs; and
- the Holistic Framework for the Assessment and Mitigation of Systemic Risk in the Insurance Sector (the **Holistic Framework**).

The adoption of the frameworks, in addition to being an important step in the regulation of the largest global insurers, is also expected to drive the development of insurance regulation worldwide, with many national insurance supervisors expected to look to the IAIS approach when designing their own local capital and other regulatory systems.

ICS VERSION 2.0

The ICS aims to establish a group-wide capital standard that will enable evaluation of insurance group health across jurisdictions on a comparable basis. In many respects, the ICS, with its market-adjusted valuation approach, adopts the European Solvency II method of valuing group capital, and U.S. insurers and regulators have objected to this approach. The implementation of the ICS will begin in January 2020 with a five-year monitoring period, which will include confidential reporting by insurance groups to their supervisors but will not trigger supervisory action. The IAIS expects the monitoring period to include additional public consultations, data analysis and supervisory feedback, all of which will lead to further refinement of the ICS before it is designated a group-wide prescribed capital requirement.

Prior to the annual meeting, U.S. insurance regulators and other government officials had publicly warned that the ICS would not be adopted in the U.S. In September, the president of the National Association of Insurance Commissioners (the **NAIC**), representing U.S. state insurance regulators, testified before the U.S. Senate that U.S. insurance regulators would not adopt the ICS in its current form. On November 13, a group of 30 senators signed a letter to U.S. Treasury Secretary Steven Mnuchin, raising concerns about the ICS and the monitoring process. Previously, the IAIS had agreed to consider whether the aggregation method being developed by the U.S. will be deemed comparable to the ICS. Comparability would allow U.S. insurance groups to satisfy prescribed capital requirements by calculating capital according to the aggregation method rather than ICS. At the annual meeting, the IAIS agreed to a definition of comparable outcomes and an approach to the development of the criteria that will be used to assess comparability, as well as a timeline for such determination. While the IAIS urges IAIGs to participate, according to the NAIC's interpretative guidance on the comparability assessment framework, U.S. IAIGs will not be required to participate in the monitoring period with respect to the ICS.

Other key aspects of the ICS include:

"Reference ICS" and other valuation methods. The confidential reporting during the monitoring period will be on the basis of a "reference ICS", following a market-adjusted valuation approach and applying a standard method for calculation. At the option of the relevant group-wide supervisor, additional ICS reporting, including calculations based on so-called "GAAP Plus" methodologies (which start with IAIG's GAAP accounting measures, with adjustments made for prudential purposes), as well as the use of internal models, will be allowed at the discretion of the group-wide supervisor. The IAIS stated that both GAAP Plus and other methods of calculation of the ICS capital requirement are viable options that will be considered for inclusion in the ICS by the end of the monitoring period.

Qualified Capital. The ICS identifies two tiers of qualifying capital resources to cover the required capital:

- Tier 1: financial instruments or capital elements other than financial instruments that absorb losses on a going-concern basis and in winding up. Tier 1 capital is then subdivided into unlimited and limited financial instruments.

- Tier 2: financial instruments or capital elements other than financial instruments that absorb losses only in winding-up. Tier 2 capital is then subdivided into paid-up and non-paid up financial instruments. The Tier 2 basket was increased from 10 to 15% of the ICS capital requirement.

Similar to Solvency II (but with somewhat simpler, and broader, classifications), the classification of these two tiers is focussed on the following key principles: (i) loss absorbing capacity, (ii) subordination, (iii) availability to absorb losses, (iv) permanence and (v) absence of both encumbrances and mandatory servicing costs. The classifications generally follow the framework previously specified in the IAIS's public consultations and field testing, though with some changes expected to be detailed in subsequent "Level 2" guidance early next year.

Disclosure. Industry participants have raised concerns that third parties, such as analysts, rating agencies or financing counterparties, may require disclosure of ICS results. Although IAIGs are not prohibited from public disclosure, the IAIS made clear, as it has in the past, that reporting of ICS results to group-wide supervisors will be on a confidential basis, and encouraged IAIGs not to disclose their ICS results to any third parties. The documentation released by the IAIS following the meeting also included statements that seem intended to allay concerns that the standard will need to be disclosed under applicable securities laws by the IAIGs, such as stressing that the purpose of the monitoring period is to monitor the performance of the ICS over a period of time, and not the capital adequacy of the IAIGs, and that further clarifications and corrections may be made to the standard over time.

The document released by the IAIS constituted a "Level 1" framework for the ICS during the monitoring period. More detailed specifications will be set out in a "Level 2" document, expected to be published in early 2020.

THE HOLISTIC FRAMEWORK

The Holistic Framework, which has been more recently developed by the IAIS, aims to shift from a systemic risk framework focused solely on entity risk (with a particular focus on the risks of the largest, most systemically important insurers, known as global systemically important insurers (**G-SIIs**)), to a framework that takes into account industry-wide risks arising from specific activities and exposures, as well as the concentration of risks within individual entities. The Holistic Framework combines supervisory policy measures and powers of intervention with monitoring and assessment.

As a result of the implementation of the finalised Holistic Framework, the Financial Stability Board (the **FSB**) has continued its suspension of the annual identification of G-SIIs. In November 2022, the FSB will review whether such identification is discontinued or re-established, and it is likely that many of the measures focused solely on G-SIIs will be disbanded.

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