CLIENT UPDATE

FSB DESIGNATES G-SIIS AND RELEASES POLICY MEASURES FOR ENHANCED G-SII SUPERVISION

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On July 18, 2013, the Financial Stability Board (FSB) released its initial list of nine global systemically important insurers (G-SIIs) and the policy measures that will apply to them as implemented by their national authorities.[1] Simultaneously, the International Association of Insurance Supervisors (IAIS) released its G-SII initial assessment methodology paper, as well as a more detailed document describing the G-SII policy measures.[2] The policy measures document finalizes, at least for now, measures based upon those proposed by the IAIS in its policy measures proposal of October 2012.[3] The FSB's release also states that by the end of 2013 the FSB will agree with the IAIS on a timeline to finalize a comprehensive, group-wide supervisory and regulatory framework for internationally active insurance groups (IAIGs), including a quantitative capital standard, extending the importance of the FSB's announcement to international insurers beyond those designated as G-SIIs.

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1 The nine insurers are 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.

2 The IAIS documents can be found at http://www.iaisweb.org/G-SIIs-988.

3 The proposed measures can be found at http://www.iaisweb.org/view/element_href.cfm?src=1/16647.pdf.

The new measures rely on the same three recommendations as the earlier proposal: enhanced supervision, effective resolution, and higher loss absorption (HLA) capacity, but add an important fourth measure, loss absorption (LA) capacity.[4] The final measures rely to a greater extent than the proposed measures on other work being done at the IAIS, particularly the development of the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). Under the new measures, a G-SII will be subject to group-wide supervision and group-wide resolvability assessments, as well as a higher capital requirement, part of which will be calculated on the basis of engagement in non-traditional (NT) and non-insurance (NI) activities, and part of which will be uncorrelated to any particular activity.

The FSB deferred until July 2014 any decision on G-SII designation of reinsurers to provide more time to analyze the individual candidate companies, as well as to identify policy measures to mitigate systemic risk for reinsurance. The IAIS believes that substitutability and interconnectedness, which it did not see as indicia of great systemic risk in traditional insurers, could potentially cause greater systemic stress from reinsurers.

BACKGROUND

In response to the recent global economic crisis, the G-20 and the FSB initiated a global effort to identify global systemically important financial institutions, and to mitigate the risks these institutions pose to the global economy. Acting on a request from the FSB, in November 2011 the Basel Committee on Banking Supervision finalized a framework for identifying global systemically important banks (G-SIBs), and requiring additional loss absorbency in those institutions. At the same time, the FSB announced its first list of G-SIBs, which it revised on November 1, 2012. Subject to the supervision and endorsement of the FSB, the IAIS has been engaged in an analogous process of identifying G-SIIs, and establishing risk mitigating measures for those institutions.

INITIAL ASSESSMENT METHODOLOGY

The assessment methodology released on July 18 is intended to "identify insurance-dominated financial conglomerates whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity."[5]

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4 For a discussion of the proposed policy measures, please see http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=8c8c5cf5-6875-438a-8d31-2f1c2dfc4eb4.

5 The Initial Assessment Methodology can be found at http://www.iaisweb.org/G-SIIs-988.

The IAIS applied its initial assessment methodology using year-end 2011 data collected from certain insurers in 2012. The initial assessment methodology has three steps: collection of data, a methodical assessment process, and a supervisory judgment and validation process. The process emphasizes a company's engagement in NT and NI activities, and de-emphasizes size and global activity.

For most insurers, the IAIS used an "indicator-based" assessment approach, which involved weighing five categories of attributes of an insurer: size, global activity, interconnectedness, participation in NT and NI activities, and substitutability of the insurer's products. The two categories that receive the most weight are NT and NI at 45%, and interconnectedness, at 40%, with the other three receiving 5% each.

According to the IAIS, NT and NI activity is an important factor because insurance liabilities can usually be managed over a long time frame, but this may not be the case when NT and NI activities are present. Interconnectedness is important because of the potentially strong connection between the banking and insurance sectors. It is notable that while size and global activity factor into the initial data collection step, they are very small components of the indicator-based assessment approach, even though this is a global assessment project.

POLICY MEASURES

The G-SII policy measures are based on the premise that the traditional insurance business model is not inherently systemically risky. Consistent with the assessment methodology, the policy measures suggest the IAIS' belief that systemic risk in insurers arises from NT and NI activities, and can reverberate around the financial system.

The policy measures published on July 18, 2013 are similar to the proposed policy measures published on October 17, 2012, with some notable changes. The policy measures still rely on the principles of enhanced supervision, effective resolution and higher loss absorption. One significant addition is loss absorption capacity, which will require G-SIIs to hold regulatory capital for all group activities after the requirements are completed in 2014.

Another important addition is the introduction into the G-SII process of a concept long-discussed as part of the ComFrame process: development of a "quantitative capital standard" for IAIGs. The IAIS intends to develop a work plan for the development of a quantitative capital standard for the insurance sector by October 2013, along with other comprehensive, group-wide standards for IAIGs.

Enhanced Supervision

The first measure, enhanced supervision, applies to G-SIIs immediately. The IAIS' enhanced supervisory concept relies on the identification of a group-wide supervisor, who will have direct powers over group holding companies, and will oversee the development and implementation of a systemic risk management plan (SRMP). The group-wide supervisor will help the company identify systemically risky activities, and reduce those risks. This could involve separation of NT and NI activities, or restrictions and prohibitions on those activities. It does not appear that the IAIS intends for the group-wide supervisor to expend much of its efforts focusing on reduction of risk factors other than NT and NI activities, like interconnectedness.

Group-wide supervision, according to the IAIS, should be conducted through the use of supervisory colleges. The measures suggest that a group-wide supervisor may be identified through other IAIS processes, including the Insurance Core Principles and ComFrame. Implementation of the enhanced supervisory measures is expected to begin immediately, with SRMPs due in July of 2014.

Effective Resolution

The second policy measure requires G-SIIs to plan for their own financial distress or resolution, in coordination with their group-wide supervisor. The relevant authorities must establish a crisis management group (CMG), conduct resolvability assessments and have in place cooperation agreements with other supervisors to resolve a G-SII. G-SIIs must develop recovery and resolution plans (RRPs), including liquidity risk management plans. Additionally, the IAIS intends to develop a template to assist supervisors in assessing resolvability of G-SIIs.

CMGs should be established by July 2014 for current G-SIIs; RRPs are to be developed and agreed to by relevant CMGs by the end of 2014.

Higher Loss Absorption

G-SIIs will be subject to increased loss absorption capacity, which will be calculated based on the company's NT and NI activities. In the absence of a global capital standard, the IAIS intends for HLA to be built upon "straightforward, backstop capital requirements," for all group activities, including non-insurance subsidiary activities. HLA could be applied at the group or entity level, depending on where it will most effectively reduce potential systemic impact. HLA may be calculated by multiplying the required base capital amount by a percentage uplift.

The IAIS will develop the implementation details for HLA by the end of 2015, with implementation to begin from 2019.

Loss Absorption

As a foundation for higher loss absorbency, the IAIS will as a first step develop straightforward, backstop capital requirements to apply to all group activities. LA will not be calculated on the basis of any particular risk or activity; a G-SII will be required to hold this regulatory capital for all group activities. Given the longer time frame for the development of HLA requirements, the inclusion of LA suggests that, at least in the near term, G-SIIs will be subject to greater LA capital requirements to compensate for the absence of any HLA until the HLA measures are finalized.

The IAIS plans to finalize the LA requirement by September 2014.

CONCLUSION

The FSB and the IAIS continue their push to decrease what they consider to be NT and NI activities around the globe, and continue to push for a group-wide supervisor for large insurers operating in multiple jurisdictions. Like the IAIS itself, the G-SII policy measures are only standard-setting. Any actual regulation and enforcement of policy measures remain within the purview of the G-SII's functional regulator or regulators.

In the United States, in order for any policy measures to be imposed on a G-SII, the Financial Stability Oversight Council (FSOC) would need to independently determine that the company posed a threat to the financial stability of the United States under the criteria of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and designate it as a systemically important financial institution (SIFI).[6] Dodd-Frank limits FSOC's designation authority to a company's effect on the financial stability of the United States, and FSOC has no authority to broaden this mandate to include the criteria of the IAIS, except to the extent they are subsumed in the Dodd-Frank criteria. Given these constraints, the FSOC could only designate for heightened supervision a G-SII that could pose a threat to the financial stability of the United States.

Once designated by the FSOC, the Board of Governors of the Federal Reserve System (FRB), on its own or upon the recommendation of the FSOC, would be responsible for adopting any heightened supervisory measures to apply to a G-SII/SIFI "[i]n order to

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[6] Pub, L. 111-203.

prevent or mitigate risks to the financial stability of the United States."[7] No matter what policy measures the IAIS adopts in its effort to promote global financial stability, the FRB is limited by statute to imposing only those heightened supervisory measures which mitigate risks to the financial stability of the United States. This would leave the FRB as the presumptive group-wide supervisor for purposes of these policy measures. Thus, it would fall to the FRB to implement any of these policy measures on G-SIIs/SIFIs subject to the limitations of Dodd-Frank.

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Please do not hesitate to contact us with any questions.

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[7] 12 U.S.C. § 5365(a)(1).