CLIENT UPDATE

GLOBAL INSURANCE DEVELOPMENTS FOLLOWING IAIS 21ST ANNUAL CONFERENCE

CONTACTS

NEW YORK
Alexander R. Cochran
arcochran@debevoise.com

Eric R. Dinallo
edinallo@debevoise.com

David Grosgold
dgrosgold@debevoise.com

Ethan T. James
etjames@debevoise.com

Thomas M. Kelly
tmkelly@debevoise.com

Marilyn A. Lion
malion@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

Nicholas F. Potter
nfpotter@debevoise.com

John M. Vasily
jmvasily@debevoise.com

Samuel E. Proctor
seproctor@debevoise.com

LONDON
Jeremy G. Hill
jhill@debevoise.com

James C. Scoville
jcscoville@debevoise.com

Edite Ligere
eligere@debevoise.com

HONG KONG
E. Drew Dutton
eddutton@debevoise.com

Stuart J. Valentine
sjvalentine@debevoise.com

FRANKFURT
Peter Wand
pwand@debevoise.com

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.

This memorandum provides background about the critical features of this framework and 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.

INTRODUCTION

In response to the financial crisis, the G20 and the Financial Stability Board (the "FSB") have initiated an effort to reform the global financial system. As part of this effort, the FSB and multi-lateral standard-setting organizations have worked to establish global regulatory standards for various elements of the financial system, including the insurance sector. To that end, the standard-setting body for the insurance sector, the IAIS, is working with the FSB to establish global regulatory standards for G-SIIs and internationally active insurance groups ("IAIGs"). Once promulgated, the standards must be implemented by individual jurisdictions to have legal effect. We provide an overview of these standards below.

OVERVIEW OF IAIS STANDARDS FOR G-SIIS AND IAIGS AND IAIS CONFERENCE DEVELOPMENTS

Scope

G-SIIs

In July 2013, the FSB designated nine G-SIIs using a five-category assessment methodology developed by the IAIS.[1] The categories are: (i) size; (ii) global activity; (iii) interconnectedness; (iv) non-traditional insurance/non-insurance ("NTNI") activities[2]; and (v) substitutability, with the most important considered by the IAIS to be the level of interconnectedness and NTNI activities. The list of designated G-SIIs will be updated every November, starting in November 2014, using the IAIS assessment methodology.

IAIGs

Under the IAIS Common Framework for the Supervision of IAIGs ("ComFrame"), an insurance group is an IAIG if it meets certain criteria as to international activity and size.

- International Activity. Premiums written in three or more jurisdictions and percentage of gross premiums outside home jurisdiction constitute at least 10 percent of the group's total gross written premium.
- Size. Total assets of at least $50 billion or gross written premiums of at least $10 billion.[3]

Importantly, an IAIG may be (i) an insurance group that conducts only insurance business; (ii) a financial conglomerate dominated by insurance business that also includes other financial business, such as banking or securities; (iii) part of a financial conglomerate dominated by other financial business; or (iv) part of a diversified conglomerate including

---

1 The nine current G-SIIs 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. *See* FSB, *FSB Identifies Global Systemically Important Insurers (G-SIIs) and the Policy Measures That Will Apply to Them* (July 18, 2013), http://www.financialstabilityboard.org/publications/r_130718.htm; IAIS, *G-SIIs: Initial Assessment Methodology* (July 18, 2013), http://www.iaisweb.org/view/element_href.cfm?src=1/19151.pdf.

2 NTNI activities include (i) non-policy holder liabilities and non-insurance revenues from financial activities; (ii) derivatives trading; (iii) short-term funding; (iv) financial guarantees; (v) minimum guarantees on variable insurance products; (vi) intra-group commitments; and (vii) highly liquid insurance liabilities.

3 IAIS, *ComFrame Revised DRAFT* (Sept. 2014), http://www.iaisweb.org/view/element_href.cfm?src=1/23156.pdf.

non-financial activities. Thus, a financial group need not be primarily engaged in insurance underwriting in order to be considered an IAIG.

Direct regulators (and not the IAIS or the FSB) are responsible for identifying financial groups as IAIGs. The IAIS expects that approximately fifty companies will be designated IAIGs pursuant to the announced criteria.[4]

Regulatory Capital

G-SIIs

The IAIS capital framework for G-SIIs is composed of two components: (i) BCR and (ii) higher loss absorbency ("HLA") requirements, which build on the BCR and are intended to address G-SII's systemic importance in the international financial system. Following the release of two consultative documents on the BCR in 2013 and 2014, the IAIS released the final BCR framework on October 23.[5] The HLA is due to be completed by the end of 2015 and to apply to G-SIIs from 2019.

BCR. The final BCR framework largely follows the proposal outlined by the IAIS in its consultation paper published in July 2014. The BCR uses a factor-based approach to determine the level of Required Capital for G-SIIs, calculated on a consolidated group-wide basis. It consists of three components: (i) insurance; (ii) banking, which uses the Basel III Leverage Ratio; and (iii) non-insurance financial activities not currently subject to regulatory capital requirements.[6] An additional component for material non-financial activities will be added following further field testing.[7] Fifteen factors apply risk weightings across Traditional Life, Traditional Non-life, Non-Traditional and Asset segments. The factor values, which are largely the same as those proposed in the consultation papers, that will initially be applied to the various factors are as follows:

---

4 IAIS, *Frequently Asked Questions for the IAIS ComFrame* (Oct. 9, 2013), http://www.iaisweb.org/view/element_href.cfm?src=1/20047.pdf.

5 IAIS, *BCR for G-SIIs: Proposal* (Dec. 16, 2013), http://www.iaisweb.org/view/element_href.cfm?src=1/20710.pdf; IAIS, *BCR for G-SIIs* (July 9, 2014), http://www.iaisweb.org/view/element_href.cfm?src=1/22594.pdf; IAIS, *BCR for G-SIIs* (Oct. 23, 2014), http://www.iaisweb.org/view/element_href.cfm?src=1/23741.pdf (hereinafter "*Final BCR*").

6 IAIS, *Final BCR* at 8.

7 IAIS, *Final BCR* at 8 & 16.

BCR segment	Proxy measure for risk exposure	Factor	Factor value
Traditional Life (TL)			
Protection life	Net Amount At Risk	a_1	0.06%
Participating products	Net Current Estimate[8]	a_2	0.6%
Annuities	Net Current Estimate	a_3	1.2%
Other life	Net Current Estimate	a_4	0.6%
Traditional Non-life (TNL)			
Property	Premium Measure	b_1	6.3%
Motor	Net Current Estimate	b_2	6.3%
Casualty	Net Current Estimate	b_3	11.3%
Other non-life	Net Current Estimate	b_4	7.5%
Non-Traditional (NT)			
Variable annuities	Notional Value	c_1	1.2%
Mortgage insurance	Risk in Force	c_2	4.0%
GICS & Synthetic GICS	Notional Value	c_3	1.1%
Other non-traditional	Net Current Estimate	c_4	1.3%
Assets (A)			
Credit - investment grade	Fair Value	d_1	0.7%
Credit - non investment grade	Fair Value	d_2	1.8%
Equity, real estate & non-credit investment assets	Fair Value	d_3	8.4%

A scalar is then applied to the calculation in order to calibrate the amount of Required Capital at the level desired by the IAIS.

The final BCR framework classifies qualifying capital as either "core" or "additional". A G-SII's BCR ratio is determined by summing Core Capital and Additional Capital, applying certain deductions, exclusions and adjustments, and then dividing by Required Capital.[9] Core Capital is permanent capital that is fully available to cover losses of the insurer at all times on a going-concern and winding-up basis, while Additional Capital is

[8] "The current estimate reflects the expected present value of all relevant future cash flows that arise in fulfilling insurance obligations, using unbiased, current assumptions." IAIS, ICP On-line Tool, http://www.iaisweb.org/index.cfm?pageID=689&icpAction=listIcps&icp_id=18&showStandard=1&showGuidance=1&showIntroGuidance=1.

[9] IAIS, *Final BCR* at 19 & Annex D.

subordinated to the rights of policyholders and provides additional loss absorption capacity for losses arising in winding-up.[10] 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.[11]

The final BCR does not reflect many of the criticisms raised in the comments to the July consultation paper and elsewhere. Most fundamentally, the BCR continues to apply a market adjusted valuation approach in order to provide for comparability of outcomes across jurisdictions. Liabilities are generally discounted using IAIS-specified discount curves (based on risk adjusted liquid interest rate swaps or government bonds for the relevant jurisdiction), while financial instruments are generally adjusted to fair value as determined under the G-SII's applicable IFRS or GAAP standards for reporting or disclosure purposes. Many argue that the market adjusted valuation approach will be excessively volatile and pro-cyclical, although the IAIS notes that this will be reviewed in the development of the Insurance Capital Standards ("ICS") applicable to IAIGs (see below).[12] Many other issues – such as the impact of diversification and asset-liability management on the capital standard – were deferred for consideration in the design of the ICS, so that the BCR could remain a simplified capital standard.

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 (between the Prescribed Capital Requirement and the Minimum Capital Requirement under Solvency II).[13] 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 HLA requirements – which will be added to the BCR for G-SIIs – are finalized, which is expected to happen by the end of next year. The IAIS stated that it may reconsider BCR calibration levels once the HLA is determined.

HLA. The IAIS believes that "G-SIIs should have higher loss absorption capacity to reflect the greater risks that they pose to the global financial system and the global economy."[14] To that end, G-SIIs will be required to maintain HLA capacity in addition to the BCR. HLA is composed of (i) a "base" capital requirement, which will vary based on the type of

10 IAIS, *Final BCR* at 19 & Annex D.

11 IAIS, *Final BCR* at Annex D.

12 IAIS, *Final BCR* at 42.

13 IAIS, *Final BCR* at 21.

14 IAIS, *G-SIIs: Policy Measures* (July 18, 2013) at 27, http://www.iaisweb.org/view/element_href.cfm?src=1/19150.pdf.

activities conducted by the G-SII and the entity in which the activity is conducted; and (ii) a percentage uplift applied to the G-SII's NTNI activities. The percentage uplift for NTNI may be reduced if the G-SII demonstrates "effective separation" of its NTNI activities. The HLA is expected to be applied to the entity where NTNI activities are carried out.

The HLA is scheduled to be adopted in November 2015 and applied to G-SIIs from 2019. Initially, the BCR will be the foundation for the HLA, but once the ICS is adopted, the ICS is expected to replace the BCR.

IAIGs

The IAIS is developing a risk-based group-wide ICS for IAIGs. The ICS will be informed by the development of the BCR, will be completed by the end of 2016, and applied to IAIGs in 2019 after refinement and calibration in 2017 and 2018. It is intended to be a comprehensive framework, so the IAIS expects to consider certain business risks, such as operational and liquidity risk, that are not accounted for in the BCR.[15] The ICS 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.

The current draft of ComFrame provides a "placeholder" for the ICS, in anticipation of further development of the BCR and HLA. The IAIS states that once the ICS is developed, the BCR and HLA will be reassessed using the ICS as a foundation.

Anticipated milestones for the development of the BCR, HLA and ICS are shown in the following chart:

Timing	Milestone
Nov. 2014	G20 Leaders expected to endorse final BCR proposal
Dec. 2014	Initial consultation document on ICS released
From 2015	Confidential reporting of BCR to group-wide supervisors with access by the IAIS for the purpose of reviewing and refining the BCR
Feb. 2015	Deadline for responses to the ICS consultation document
Mar. to Sept. 2015	Field testing of HLA and ComFrame, including ICS
Nov. 2015	HLA proposal to be finalized and endorsed by G20
Mar. to Sept. 2016	Further field testing of ComFrame, including ICS
Dec. 2016	ICS to be agreed, subject to further refinement via field testing

15 IAIS, *Final BCR* at 12.

Timing	Milestone
2017 and 2018	Further refinement of ComFrame, including ICS, via field testing
Late 2018	ComFrame, including ICS, to be adopted by IAIS
From 2019	Implementation of ComFrame, including ICS, to commence
From 2019	HLA commences to apply to G-Slls, initially based on BCR as a foundation, later to be based on ICS as a foundation

Resolution Planning

Resolution planning was a key area of discussion at the IAIS conference. The FSB and IAIS intend for G-SIIs to develop recovery and resolution plans to (i) to avoid severe systemic disruption and to protect taxpayers from exposure to loss; (ii) to control loss absorption by maintaining a claims hierarchy in the event of the G-SII's liquidation; (iii) prioritize the protection of policyholders during winding up and liquidation proceedings; and (iv) ensure that non-viable G-SIIs can exit the market in an orderly fashion. G-SIIs designated in 2013 must complete recovery and resolution plans by the end of 2014. Unlike for G-SIIs, ComFrame does not require IAIGs to prepare recovery and resolution plans. Rather, ComFrame contemplates that IAIGs will develop contingency plans and procedures that enable them to deal with crisis situations, maintain an acceptable financial condition and protect policyholders.

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 IAIGs. The FSB has published the general framework for these plans, *Key Attributes of Effective Resolution Regimes of Financial Institutions*, and this month provided updates to the framework focused on insurers.[16] The regulators on the panel noted that in addition to being an important protection for taxpayers, they also will view the plan as a good risk management technique for affected companies.

Regulators on the panel recognized that insurers differ from banks (for example, it may be more difficult to determine "critical functions" with insurers) 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

[16] FSB, *Key Attributes of Effective Resolution Regimes of Financial Institutions* (Oct. 15, 2014), http://www.financialstabilityboard.org/publications/r_141015.pdf.

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 systemically important financial institutions, AIG and Prudential, as informative models for both process and content. The FDIC representative stated that comments on those plans will be provided to the insurers soon, and that in any event (as with the banks), the agencies expect increased analysis with each succeeding plan. 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. Among other issues, the panelists noted that the regulatory regime will have to address how to maintain the confidentiality of a plan applying to a multi-jurisdictional institution.

D. Enhanced Supervision

The IAIS views an enhanced supervisory framework as a critical element of the regulatory apparatus for G-SIIs, and thus the IAIS policy measures for G-SIIs include a variety of requirements relating to enhanced supervision, including group-wide supervision, development of systemic risk management plans, enhanced liquidity planning and management, and the effective supervision of NTNI activities. In addition, the IAIS contemplates that G-SIIs will undertake additional prudential measures to reduce potential systemic risks, including effective internal controls, appropriately diversified investment and reinsurance activities, heightened disclosure and stress testing obligations as compared to other firms.

As with G-SIIs, the IAIS believes group supervision is a "fundamental" element of ComFrame, which contemplates that supervisors will have direct powers over the IAIG's head.[17] Like the G-SII framework, ComFrame anticipates that an IAIG will be subject to group supervision, will have a group-wide supervisor and will manage itself on a group-wide basis.

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

[17] IAIS, *ComFrame Revised DRAFT* at 3.

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.[18]

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 IAIS 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

The IAIS standards for G-SIIs and IAIGs reflect an emerging view as to how financial institutions, including insurers, should be regulated. Consequently, the standards will have significant impacts on the insurance sector.

Most visibly, in light of the recently released final BCR framework, enhanced capital standards will have a significant impact in the near-term on G-SIIs and, over the longer term, on IAIGs and potentially on other insurers should domestic regulators opt to enlarge the reach of the standards. First, in order to fully comply with the new global capital standards, G-SIIs and IAIGs may need to fundamentally restructure the type and quantity of capital held. Accordingly, these insurers will need to work with regulators to raise

[18] http://www.financialstabilityboard.org/publications/140407.pdf.

capital necessary to meet IAIS standards and to develop new and innovative capital instruments.

Enhanced capital standards also may lead to follow-on effects in firm structure. For example, as certain activities become more capital intensive, and therefore less profitable, insurers may become more active in mergers and acquisitions. Such a trend has precedent in European insurers' sales of U.S. operations in anticipation of Solvency II. Regulators may be hesitant to encourage consolidation and perceived systemic risks in the insurance sector, so it is possible that non-G-SIIs will experience greater M&A opportunities.

The new standards' negative treatment of NTNI activities may also have a significant impact. Group-wide supervisors may require G-SIIs to effectively separate NTNI from their insurance businesses in order to reduce or mitigate systemic risks, leading G-SIIs to seek to divest or restructure these activities. The HLA additional capital requirements, which are explicitly designed to discourage NTNI activities, may also lead to the divestment or restructuring of those activities.

It is currently unclear to what extent G-SII resolution planning will have a substantial impact on these firms and the extent to which resolution planning requirements may be extended to IAIGs and other non-G-SII insurers.

Finally, due to ComFrame's governance and risk management requirements, IAIGs will need to place greater emphasis on group-wide strategy, management and planning. These group-wide standards have the potential to deter more risky investments for insurers and may increase the difficulty of obtaining regulatory approval for new activities.

CONCLUSION

The development of global insurance standards by the IAIS is one component of an overall effort to reform the global financial system in response to the financial crisis. As with other parts of this effort (*e.g.*, Basel Committee on Banking Supervision reform of banking sector standards), the IAIS process is far from complete, and thus the ultimate impact remains unknown. In any event, it is clear that the IAIS and standards it develops will have a significant impact on the evolving regulatory framework for insurers worldwide.

* * *

Please do not hesitate to contact us with any questions.

October 31, 2014