

Client Update

IAIS Begins Public Consultation on Higher Loss Absorbency Standard for Global Systemically Important Insurers

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INTRODUCTION

On July 8, 2015, the International Association of Insurance Supervisors (“IAIS”) held a public background briefing to its public consultation document (“Consultation”) on the development of higher loss absorbency (“HLA”) requirements for global systemically important insurers (“G-SIIs”) issued on June 25, 2015. The purpose of the background briefing was to encourage a greater degree of public engagement with the consultation process.¹

The Consultation is another significant step in the multi-year IAIS process to develop global regulatory capital standards for G-SIIs and internationally active insurance groups (“IAIGs”). As part of this process, the IAIS on October 23, 2014 finalized the basic capital requirement (“BCR”), which, together with the HLA, serves as the primary component of the G-SII capital framework.² In addition, the IAIS in December 2014 issued a public consultation document on the insurance capital standard for G-SIIs and the wider group of IAIGs.³

¹ At present, there are nine designated G-SIIs: (i) Allianz SE; (ii) American International Group, Inc; (iii) Assicurazioni Generali S.p.A; (iv) Aviva plc; (v) AXA S.A.; (vi) Metlife, Inc.; (vii) Ping An Insurance (Group) Company of China, Ltd; (viii) Prudential Financial, Inc.; and (ix) Prudential plc. The Consultation Document is available at: <http://iaisweb.org/index.cfm?event=showNewsDetails&persistId=78C9329F155D896B00C0ADA2C9142E58>.

² IAIS, BCR for G-SIIs (Oct. 23, 2014).

³ IAIS, Risk Based Global Insurance Capital Standard: Public Consultation Document (Dec. 17, 2014), available at <http://iaisweb.org/index.cfm?event=showHomePage&persistId=7F6DD507155D896B0064888B48B464F5>. For additional analysis of the BCR and ICS, please see our client

The IAIS expressly seeks comments on the Consultation from the public generally, with an August 21, 2015 submission deadline. All comments will be published on the IAIS's website unless a specific request is made for comments to remain confidential. The IAIS is expected to complete its review of the comments by October 2015, with expected endorsement of the HLA at the November 2015 G20 Leaders' Summit in Antalya, Turkey.

We summarize key aspects of the HLA Consultation below.

EXECUTIVE SUMMARY

- The IAIS proposes a factor-based HLA standard that would separate, and establish required capital amounts for, a G-SII's insurance and non-insurance (“NI”) activities. The Consultation states that the HLA standard will increase a G-SII's BCR capital requirement (as increased through an anticipated “uplift”) by an average of 20%, though the individual impact will vary by firm and the ultimate contours of the HLA formula.
- Importantly, the Consultation is generally open-ended in its treatment of a G-SII's traditional insurance, non-traditional insurance (“NT”) and NI activities for purposes of the HLA formula. However, the Consultation notes that the NT and NI components in the BCR were relatively low, suggesting that the HLA may put a relatively greater emphasis on those activities if it is to serve one of its express purposes of providing a disincentive to activities perceived to pose systemic risk.
- The implications of the Consultation for insurance enterprises designated by the Financial Stability Oversight Council (“FSOC”) for supervision by the Federal Reserve Board (the “FRB”) are unclear. It is possible, however, that the HLA framework may eventually inform the potential application of a capital surcharge by the FRB to these firms under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- The Consultation raises important legal and policy questions relating to appropriate capital and supervisory standards for G-SIIs and for IAIGs.

THE CONSULTATION DOCUMENT

The primary purpose of the HLA is to reduce the probability and impact on the financial system of the distress or failure of a G-SII. For these purposes, the IAIS

updates at <http://www.debevoise.com/insights/publications/2015/01/iais-issues> and <http://www.debevoise.com/insights/publications/2014/10/global-insurance-developments-following>.

defines systemic risk as the “risk of disruption of financial services which is caused by the impairment of all or parts of the financial system and has the potential for serious negative consequences for the real economy.”⁴

The HLA is expected to be presented to the G20 for endorsement in November 2015 and apply to G-SIIs from 2019, following enactment of specific rules in local jurisdictions.

Once the HLA is implemented, G-SIIs will have to hold qualifying regulatory capital (capital of the highest quality) that is not less than the sum of the required capital amounts from the BCR and the HLA.

OBJECTIVES OF THE HLA

The main objectives of the HLA include:

- internalizing some of the costs to the financial system and overall economy by making G-SIIs more resilient to low-probability, high-impact events;
- allowing for earlier supervisory intervention and more time to address emerging risks;
- providing disincentives to carrying out activities which may pose a threat to the financial system; and
- offsetting any benefit that may arise through association with G-SII status.

THE HLA PROPOSALS

The HLA requirement would: (a) be a group capital requirement applicable to all G-SIIs based on a going concern approach; (b) apply to all group activities and subsidiaries of the G-SII, including non-insurance subsidiaries; and (c) impose higher levels of group regulatory capital on those groups designated as G-SIIs than those designated as non-G-SIIs. Disincentives are expected to be built into the HLA design to encourage G-SIIs to reduce potential systemic activities.

The HLA would be calculated by separating a G-SII’s insurance and NI business so that existing global regulatory requirements in non insurance sectors may be reflected. The overall impact of the HLA is determined by the amounts of HLA

⁴ See Report to G20 Finance Ministers and Governors, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, October 2009.

from both insurance and NI business, and within insurance, by the amount of traditional and NT activities.

The HLA would, together with the BCR, constitute a global minimum capital standard for G-SIIs. A G-SII's total BCR and HLA-required capital would be composed of the following three components, each for a G-SII's insurance and non insurance business:

- the BCR;
- the uplift—an amount added to the BCR; and
- the HLA—additional capital requirements over and above the BCR uplift requirements.

The uplift capital amount, for both insurance and NI, is designed to increase the BCR to reduce the expected gap between the BCR and the future ICS, which is currently expected to be finalized by 2019. Subject to regulatory requirements specified by global rules for other sectors (for example, banking), the Consultation states that the working assumption for the uplift is 33% of the current BCR.

For G-SIIs, the HLA capital amount for both insurance and NI business is expected to increase the sum of the BCR and uplift by an amount that does not exceed 20%. The HLA-required capital relating to regulated banking activities is not expected to exceed the relevant regulated banking requirements for those activities.

HLA FORMULA

It is proposed that the HLA-required capital formulas, for both insurance and NI, be factor based. A required capital amount (the outcome) is the product of multiplying two inputs, a factor and an exposure. The IAIS is consulting on three main issues in the design of HLA-required capital formulas:

- bucketing (to specify which factor to apply to which G-SII);
- choice of HLA formulas, in particular, what additional emphasis, if any, should be placed on NTNI activities; and
- calibration of outcomes. There is a choice of the extent of the impact that the HLA is to have on G-SIIs, both on average and, in particular, recognizing the differences in the business models of different G-SIIs.

The Consultation does not set out specific HLA formulas for consideration, stating that those will not be decided until after further field testing. However, it indicates that it expects the HLA to be calibrated so that the total HLA insurance formula would produce results of up to 20% of the uplifted BCR insurance formula. Also, as the BCR for NTNI activities was relatively low (based on field testing in 2014, 13% of the total BCR was attributable to NI activities and a further 6% to NT activities), the HLA components for those activities may be larger, to provide the desired disincentive effect as contemplated in the HLA design. The regulated banking component of the HLA for NI would be capped by the relevant limit derived from the applicable banking requirements.

HLA IMPLEMENTATION TIMEFRAME

06/25/2015 – 08/21/2015	Consultation period
July 2015	Field testing of data relevant to the development of HLA
By October 2015	Analysis of consultation and field testing HLA document provided to G20
November 2015	Expected endorsement by G20
2016-2018	Ongoing refinements of the BCR and HLA
From January 2019	BCR and HLA requirements to be applied to all G-SIIs
Late 2019	ComFrame, including ICS to be adopted by IAIS
Post 2019	HLA revision in accordance with ICS development completion

CONCLUSION

At present, the practical impact of the Consultation is difficult to predict with certainty. Indeed, the open-ended nature of the document suggests that the final form of the HLA itself is still opaque. In addition, by directly addressing an important policy issue, namely, whether a group-wide systemic risk-focused capital surcharge is appropriate for G-SIIs, the Consultation invites consideration of related issues and implications, such as the relationship between the HLA standard and G-SII resolution framework and the potential inappropriate incorporation of bank-centric concepts, e.g., the Basel Committee on Banking Supervision concept of “total loss absorbency capacity,” into the insurance capital framework.⁵ However, it does appear reasonably certain that the

⁵ See Financial Stability Board, *FSB consults on proposal for a common international standard on Total Loss-Absorbing Capacity (TLAC) for global systemic banks* (Nov. 10, 2014),

combination of the proposed HLA, the global ICS, the entry into force of Solvency II across the EU in January 2016 and the FRB's implementation of capital standards for insurers are likely to lead to increased minimum regulatory capital requirements for G-SIIs and insurers generally.

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Please do not hesitate to contact us with any questions.

available at <http://www.financialstabilityboard.org/2014/11/fsb-consults-on-proposal-for-a-common-international-standard-on-total-loss-absorbing-capacity-tlac-for-global-systemic-banks/>.