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# Regulatory brief

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## Systemically important insurers: Global follows US lead

### Overview

On July 18, 2013, the International Association of Insurance Supervisors (IAIS) published a methodology, endorsed by the Financial Stability Board (FSB), for identifying global systemically important insurers (G-SIIs) and a set of policy measures governing them. Using this assessment methodology, the FSB identified an initial list of nine G-SIIs, in consultation with the IAIS and national authorities. The firms – which include three US firms – are the following: Allianz, American International Group, Assicurazioni Generali, Aviva plc, Axa, MetLife, Ping An Insurance (Group) Company of China, Prudential Financial, and Prudential plc.

This development follows the recent designations by the Financial Stability Oversight Council (Council) of AIG and Prudential as nonbank systemically important financial institutions (which Prudential is in the process of contesting), and the advancement of MetLife to the final stage of analysis before designation may be proposed (per MetLife's public disclosure).[1] Although there had been speculation that the Council would wait for the release of the FSB list, it did not.

The IAIS methodology, which is focused solely on insurers, differs from that used by the Council; however, the outcome under the IAIS's and US's approach is the same (if Prudential and MetLife are both ultimately designated in the US). Unlike the US, the IAIS focused on two primary factors: Non-traditional, Non-insurance (NTNI) activities and interconnectedness. Recognizing that there are differences between banks and insurance companies in terms of the nature and degree of risk they pose to the global financial system, the IAIS's focus on NTNI and interconnectedness indicate their position that size should not be the driving force behind designation – and that size is in fact helpful for an insurer's financial security.

The policy measures that will apply to G-SIIs include (i) recovery and resolution planning requirements, (ii) enhanced group-wide supervision and (iii) higher loss absorption requirements. However, since the FSB lacks legislative or supervisory authority, the policy framework is not binding on any G-SII until implemented by individual countries.

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[1] We anticipated last month that another insurer would soon enter this stage and ultimately be proposed for designation by "early 2014," a timeframe that seems to be coming to fruition based on how long it took for AIG and Prudential to be proposed for designation after they reached the final stage last year. See *PwC's FS Regulatory Brief: FSOC proposes initial designations – more names to follow* (June 2013).

The US nonbank systemically important financial institutions (SIFIs) meanwhile will be subject to supervision by the Federal Reserve Board (FRB) and to proposed enhanced prudential standards under the Dodd-Frank Act that broadly apply to both bank and nonbank SIFIs, subjecting them to a more comprehensive bank-centric approach. It remains to be seen how much this approach will be "tailored" to insurers, as described in the proposed standards. Importantly, in a positive sign for insurers, the FRB has recently shown some willingness to make adjustments for insurance company owners of thrifts as part of its final rule this month implementing Basel III's capital requirements.[2]

Therefore, the key takeaways as we see it are: the Council's view of which US insurers are G-SIIs has been mirrored at the FSB; the differing designation methodologies did not matter; the US G-SIIs will face more bank-centric requirements than their global competitors; and the US will continue to act first as necessary toward the next round of systemically important institution designations.

This **Financial Services Regulatory Brief** (a) describes the IAIS assessment methodology, (b) compares it to the US nonbank SIFI designation process, (c) analyzes the IAIS standards that will apply to G-SIIs, and (d) compares them to the US framework.

## The IAIS assessment methodology

After the financial crisis, the FSB was asked by the G-20 to develop a policy framework to address the systemic and moral hazard risks associated with SIFIs, especially Global SIFIs (G-SIFIs).[3] In November 2011, the FSB published an integrated set of policy measures to address these risks and identified an initial group of global systemically important banks (G-SIBs). Since then, the IAIS was tasked with devising a methodology for G-SIIs and the policy measures that should apply to them.

The IAIS methodology for identifying G-SIIs combines three approaches for assessing the data it gathered:[4] specific metrics (referred to as "indicators"), business segment analysis ("IFS assessment"), and supervisory judgment and validation:

- ***Indicators***. The indicators-based approach considers five categories of metrics: size, global activity, interconnectedness, NTNI, and substitutability. NTNI is considered to be the most important, receiving a weighting of 45%, while interconnectedness is the second most important with a weighting of 40%. The weighting for each of the other three categories is far lower at 5% each.
- ***IFS assessment***. The IFS[5] assessment approach segments the business portfolio of an insurer into its traditional insurance, semi- and non-traditional insurance, as well as non-insurance financial and industrial activities. The approach associates risk weights commensurate with the systemic importance of these various business activities. The risk weights reflect the IAIS position that systemic importance in insurance is primarily associated with the conduct of non-insurance financial and non-traditional insurance business.
- ***Supervisory judgment and validation***. In addition to the above two quantitative methods, the IAIS held discussions with the relevant group-wide supervisors of each G-SII candidate to obtain their views on the results of the calculations that the above methods produced. Based on those assessments, and further informed by these discussions with relevant group-wide supervisors, the IAIS determined where additional analysis was required. In such cases, the IAIS obtained additional information on selected G-SII candidates from public sources and supervisors.

Beyond this information about these assessment methods, and the resulting designation as G-SIIs of nine insurers, little is known publically about how the methods were applied, or the results with respect to individual insurers. The IAIS's process to respond to the FSB's request for assistance in the designation of G-SIIs has been largely conducted in private, to the disappointment of US insurance industry representatives who have requested more open discussions.

[2] See *PwC's FS Regulatory Brief: Basel III capital rules finalized by Federal Reserve: But much more to come for the big banks* (July 2013).

[3] G-SIFIs are defined by the FSB as "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." G-SIBs are one class of G-SIFIs as are G-SIIs.

[4] In conducting its G-SII analysis, the IAIS collected non-public data from approximately fifty firms, fourteen of which are US-based.

[5] The IFS approach is based on the concepts described in *Insurance and Financial Stability*, a paper issued by IAIS in November 2011.

After the G-SII list was released, Thomas Leonardi (Connecticut's Insurance Commissioner who represents state insurance regulators on the IAIS's Financial Stability Committee) issued a statement on behalf of the National Association of Insurance Commissioners (NAIC) expressing concern with the sufficiency of the analysis to identify G-SIIs. He urged that a comprehensive comparison of G-SIIs with proposed systemically important banks be conducted to assess the threat posed by potential G-SIIs relative to financial firms in other sectors.

The list of G-SIIs will be updated annually and published by the FSB each November starting in November 2014 (as the G-SIB list is), based on the most recent data. The list is likely to evolve over time, most notably when any reinsurers identified by the methodology are designated as G-SIIs, which is expected to occur in July 2014. Reinsurers were excluded from the initial designation, as more time was considered necessary to assess issues of substitutability and interconnectedness, and to identify policy measures specifically targeted to risks posed by reinsurers.

## IAIS methodology compared to the US's

While the FSB's list of G-SIIs has been long-awaited, its ultimate import for future SIFI designations in the US is limited. The Council did not wait for the IAIS list to propose designating two G-SII US insurers as US nonbank SIFIs – AIG and Prudential Financial – and to place another G-SII insurer in the last information gathering stage before possible designation – MetLife. Input from those members of the Council who also serve on the FSB likely helps explain the correlation between the FSB's list and the Council's actions.

The Council's designation process is driven by specific statutory considerations set out in section 113 of Dodd-Frank and by its implementing rules and interpretive guidance. [6] Under this regime, the Council's approach applies to any type of nonbank financial company that may be a SIFI – not just insurance companies.

In contrast, the IAIS methodology is designed solely for ranking the global systemic impact of insurers – a different and more focused mission. The IAIS methodology views traditional insurance products as not posing systemic risk, a point of view widely supported by the US insurance industry, and by many US insurance regulators.

In a public summary of its decision designating AIG,[7] the Council took a more controversial view of the risk of traditional insurance products. For example, the Council's assessment of the asset liquidation channel for AIG was driven by its view that while AIG's life insurance and annuity product reserves and claims for benefit payments are generally considered to be long-term liabilities, a substantial portion of such liabilities are available for discretionary withdrawal with little or no penalty.

The Council therefore took the view that such products could be susceptible to a rapid withdrawal if AIG entered financial distress, which could require it to sell assets to generate additional liquidity. The Council also saw similar liquidity needs perhaps arising from policyholders taking out loans against cash values of life insurance and annuity products putting additional strain on liquidity.

NAIC's CEO, former US Senator Ben Nelson, has publicly stated that this reasoning offered by FSOC to justify the designation of AIG suggests a misunderstanding of the insurance business model and regulation of insurance. He noted that elements of the Council's rationale focused on the potential for a "run-like" scenario for certain insurance products or a broader loss of public confidence in the insurance sector; however, during the recent financial crisis state regulators monitoring surrenders and withdrawals at AIG and its competitors did not see a run or the same loss of public confidence experienced by the banking sector.

## Policy framework for a G-SII

The FSB policy measures that will apply to G-SIIs sets out a series of recommended measures to apply an enhanced supervisory approach. Since the FSB lacks legislative or supervisory authority in its own right, the policy framework is not in itself binding on any designated G-SII or supervisor.

However, the move towards enhanced G-SII supervision is widely accepted by national supervisors. US state insurance regulators have had an active voice, albeit a minority, in the IAIS's process via NAIC. The US Federal Insurance Office (FIO) has also played a role throughout the process, conducting the final data call on US insurers leading up to the G-SII designations.

[6] For an explanation of the US designation process, see PwC's *FS Regulatory Brief: The FSOC finalizes rules and guidance for designating nonbank financial companies as SIFIs – Expect very few on tap, but many on watch* (April 2012).

[7] See *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.* (July 8, 2013).

The policy measures include for each G-SII:

- Enhanced group-wide supervision, including:
  - The group-wide supervisor to have direct powers over holding companies.
  - The group-wide supervisor to oversee the development and implementation of a Systemic Risk Management Plan.
- The recovery and resolution planning requirements under the FSB's *Key Attributes of Effective Resolution Regimes* document (Key Attributes), including:
  - The establishment of a Crisis Management Group (CMG).
  - The development of a recovery and resolution plan (RRP), including a liquidity risk management plan.
  - The carrying out within the CMG of resolvability assessments.
  - The development of institution-specific cross-border cooperation agreements among relevant resolution authorities.
- Higher loss absorption requirements (HLA): In the absence of a global capital standard as a basis, HLA requirements will be built upon "backstop capital requirements for all group activities, including non-insurance subsidiaries." The backstop, to be developed by the IAIS by the end of 2014, is intended to achieve a level playing field between G-SIIs and G-SIBs, implying that the IAIS may aim to develop backstop capital requirements for insurers which are comparable to Basel III. The HLA is calculated as a simple uplift to backstop capital requirements, and is expected to be focused on NTNI activities. HLA requirements will need to be met by "the highest quality capital."

In developing these policy measures, there is an apparent emphasis on encouraging designated G-SIIs to reduce the level of systemic importance by developing a Systemic Risk Management Plan which could include measures like separating NTNI activities from the traditional insurance business, or simply restricting or prohibiting NTNI activities. Such actions will also be contributing factors to the calculation and location of the additional capital requirement to achieve the HLA. This reflects the IAIS's view that traditional insurance activities do not give rise to systemic risk, and that enhanced supervisory measures could be confined to clearly separated NTNI activities.

The FSB's G-SII measures also emphasize the role of a group-wide supervisor with prescribed regulatory authority over the group, including holding companies. This approach is similar to the approach proposed by the Solvency II Directive in Europe, but differs from the NAIC's existing approach of cooperation between a number of concerned state regulators. Whether group supervision is ultimately exercised by a group's lead state NAIC regulator, the FIO, or an international regulator, designated groups are likely to notice the changing approach, together with the increasing importance of cooperation between regulators through colleges of supervisors.

In describing the requirements related to recovery and resolution planning, the IAIS refers to the FSB's Key Attributes. However, there is a recognition that certain insurance-specific elements need to be addressed in the resolution plans of G-SIIs, especially the items delineated below (the FSB plans to issue for public consultation this summer an annex to the Key Attributes regarding the resolution of insurance groups):

1. Plans and steps for separating NTNI activities from traditional insurance activities;
2. The possible use of portfolio transfers and run off arrangements as part of the resolution of entities conducting traditional insurance activities; and
3. The existence of policyholder protection and guarantee schemes (or similar arrangements) in many jurisdictions.

The IAIS is also expected to develop, for review by the FSB, a plan to develop a wider, comprehensive, group-wide supervisory and regulatory framework for Internationally Active Insurance Groups (IAIGs), including a quantitative capital standard. They expect the timeline for the finalization of the framework will be agreed to by the end of 2013. This proposal may be controversial with US insurance regulators, who view any US insurer (no matter the home country) to be subject to the US capital regime and are generally loath to consider any proposal that would cede authority to a group supervisor overseas. This element of the IAIS's plan may also risk blurring the distinction between G-SIIs and IAIGs.

## US regulatory framework for nonbank SIFI insurers

When the Council designates an insurer or other firm as a nonbank SIFI, it subjects them to supervision by the Federal Reserve Board (FRB) and to the enhanced prudential standards of Dodd-Frank, which is a more bank-centric approach. It remains to be seen how these requirements will complement, supplement or conflict with the FSB's proposals, if at all.

These enhanced prudential standards encompass requirements dealing with risk-based and leverage capital, liquidity, single counterparty exposure limits, risk management, stress-testing, debt to equity limits, resolution planning and early remediation requirements. Under the FRB's proposed rule implementing these requirements, the FRB would apply the same set of enhanced prudential standards to nonbank SIFIs as those applied to bank holding companies.[8]

However, in its proposed rule, the FRB also conveys that a nonbank SIFI may be able to obtain "tailor[ed]" treatment, stating that "the FRB would thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards and early remediation requirements should apply." The FRB may "tailor the application of the enhanced standards to designated nonbank financial companies on an individual basis or by category, as appropriate."[9]

The FRB has so far already indicated a willingness to tailor in some fashion Basel III capital requirements for Savings & Loan Holding Companies that are "substantially engaged in commercial activities or insurance underwriting activities." However, the timing on such an alternative formulation is unclear, though both the FRB and Secretary of the Treasury Jacob Lew have indicated that the enhanced prudential standards for bank and nonbank SIFIs should be finalized before year-end, indicating more may be learned by then.

With all three US G-SIIs potentially subject to FRB regulation as nonbank SIFIs, it is possible that US rules will subject US G-SII insurers to regulatory capital or other requirements that will differ substantially from those applied to non-US G-SIIs under the FSB policy framework. The framework is based more on the systemic risks associated with the NTNI activities of the insurance industry, as opposed to the traditional insurance activities that the FSB framework considers to be non-systemic.

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[8] For more information on the enhanced prudential standards for nonbank SIFIs and the possible "tailoring" of them for insurers, see PwC's *Financial Services Regulatory Brief* in footnote 1.

[9] *77 Federal Register 594, 597* (January 5, 2012).

## What's next for the nine G-SIIs?

The exact measures that will be applied to G-SIIs in any particular regulatory jurisdiction will need to be determined by the relevant regulatory authority-holders in each territory, although in many jurisdictions the measures adopted are likely to follow the FSB's proposals to a large degree. However, a completely harmonized approach to G-SII supervision is unlikely in the near term, particularly with respect to such key regulatory issues as capital, solvency and governance.

Some additional clarity regarding the global framework for insurers will be gained later this year when the FSB issues its proposed annex to the Key Attributes regarding the resolution of insurance groups by the end of this summer, and when the timeline is finalized by year-end of the plan for a group-wide supervisory framework for IAIGs.

# *Additional information*

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