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FINANCIAL SERVICES

Evolving Insurance Regulation

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March 2011

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Foreword

Welcome to our first edition of *Evolving Insurance Regulation*. This publication is part of a series which started with the *Evolving Banking Regulation* reports published in November 2009 and November 2010.

Taking a fresh look at the various regulatory reform initiatives in the insurance sector, this report explores what the future regulatory landscape looks like, and what implications this has for insurance firms.

Although the insurance sector is sometimes described as having had a 'good crisis', this masks two key issues. First, a small number of global insurers and reinsurers encountered substantial difficulties through their participation in non-insurance activities, such as their trading in structured credit products and credit default swaps. Monoline credit and bond guarantee insurers, which have a different business model to other insurers, also experienced significant losses from their exposures to residential mortgage-backed securities. In the life insurance sector, falls in the sale of unit-linked and single premium life insurance products were accompanied by significant declines in share prices.

Second, the financial crisis has highlighted the need for more effective corporate governance and risk management in all types of financial institutions. It has reinforced the moves towards a more risk-based approach to solvency in insurance firms. In addition a number of inadequacies in supervision and regulation have been exposed, including:

- The focus of regulation being too concentrated at the individual firm level and not enough attention on group risk, and at the macro-level;
- A lack of oversight and monitoring of non-regulated subsidiaries/activities;
- Legal and legislative limitations on insurance group supervision;
- Limitations in the quality and content of supervision;
- A lack of coordination of responsibilities and an absence of coordination mechanisms among supervisors; and
- A lack of effective tools to identify and minimise regulatory arbitrage on a cross-sector and cross-border basis.

Regulatory reform initiatives to address these shortcomings are in development.

However, it is not the financial crisis alone that has inspired insurance regulators across the globe to review their regimes. The evolution of the industry is also playing a key role in influencing the outcome. For example, in developed markets, the introduction of more sophisticated products, risk management techniques, and complex financing structures impacts the regulators' approach. Improved accessibility to emerging markets, and their gradual penetration by the international players is already shaping, and will continue to inform, local regulatory reform. Further, while much focus has been on prudential regulation and within this risk and capital management, the conduct of business agenda is also a key feature, with regulators needing to strike a balance between the two in satisfying the overall consumer protection objective. As regulators of largely domestic-only markets move away from product regulation and tariffs, then the need for more attention on risk-based supervision and enhanced consumer buying safeguards is self-evident.

The International Association of Insurance Supervisors (IAIS) will introduce a new suite of Insurance Core Principles from October 2011, which will have a significant impact on the form and extent of prudential regulation globally. These changes – and their implications for insurance firms – are the core focus of this report. We welcome these initiatives, particularly the moves by the IAIS to introduce greater regulatory convergence and consistency especially for internationally active insurance groups, through the ComFrame project. We estimate that the additional cost of regulation to the global insurance sector, from having bespoke requirements in each jurisdiction, is currently in the region of US\$15bn–\$25bn.

The regulatory initiatives currently underway build on the modernisation of solvency regimes that regulators had been implementing, to shift from 'tick-box' regulatory measures towards creating an environment where prudential standards reflect better the risks faced by insurance firms on both sides of their balance sheets; and where insurance firms have stronger incentives to understand and manage their risks and their financial resources.

Moreover, some of the largest insurance firms may find themselves regarded by their regulators as being systemically important, and therefore subject to additional regulatory requirements on their financial resources and on their recovery and resolution plans.

These issues are now the subject of significant debate and development by regulators and the industry. Significant changes to solvency regulation are very likely to be the focus of much work going forward. In this report, we discuss the likely shape of reforms to come; what it will mean for prudential regulation world-wide; and the likely impact on the global insurance sector.

So, are we ready for the journey? We believe the industry is ready. There is considerable focus on the future of business models, the nature of the products, the asset allocation strategy and changes to governance and systems. Understanding the changing regulatory landscape and linking to the strategic changes has never been more important. Firms that embrace the regulatory changes and are actively involved in shaping the new reforms, stand to gain a competitive advantage and will be best prepared to meet the new challenges ahead.



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Executive Summary

The financial crisis has understandably sparked significant regulatory action. The G20, Financial Stability Board (FSB) and Joint Forum have been active in reviewing the regulatory framework for banks, and such analysis has invariably flowed across to insurance. The International Association of Insurance Supervisors (IAIS) has responded by accelerating its plans to promote common regulatory standards and greater international cooperation.

At the regional and national level, the crisis continues to influence the debate in parts of Asia, Europe and North America regarding the appropriateness of local prudential regulatory requirements and existing policyholder protection regimes. There is a diverse range of regulatory approaches across the regions, reflecting for the most part the maturity of the respective markets. For example in some countries, regulators' focus has historically been on product, tariff and conduct of business regulation, whereas in others, greater freedom has been given with the emphasis on risk and solvency regulation. As markets evolve and their uniformity gradually increases, regulatory regimes look set for greater convergence, over time.

Common themes emerging from the international regulatory developments include:

- The move towards more risk-based approaches to capital and solvency measurement;
- A greater focus on risk management and governance;
- Increased use of stress and scenario testing; and
- Group supervision.

Insurance supervisors are seeking to harmonise the approach to each of these themes and to increase cooperation and coordination through formal mechanisms. These include memorandums of understanding and the development of a project within the IAIS to build a common framework for the supervision of internationally active insurance groups. In our chapter on [ComFrame](#), we outline this framework and the significant efficiencies that could be gained by such reforms which should greatly reduce the cost of regulation.

In October 2010 the IAIS endorsed a new suite of solvency, governance and

group principles, standards and guidance, covering capital adequacy and internal models, enterprise risk management, investments, systems and controls and group supervision. The impact of these will have profound consequences for both insurance supervisors and the insurance industry. The introduction of a revised version of the IAIS's Insurance Core Principles in October 2011 heralds a significant step towards achieving international convergence and consistency in regulatory requirements.

At a global level, insurance regulators are moving towards ensuring that insurance firms are adequately capitalised with risk-based capital requirements as we discuss in our chapter on [Capital adequacy](#); requiring valuations of assets and liabilities to be on a consistent and economic basis discussed in [Accounting, valuation and disclosure](#); and preparing the way for insurance firms to use their own internal models to calculate capital requirements. These internal models will be subject to stringent standards and prior supervisory approval that should provide a better reflection of risks than a common standard formula. As we argue in our chapter on [Group and cross-border supervision](#), the introduction of group supervision through the application of these initiatives at group level is a key step change in the overall regulatory approach.

Such initiatives at the international level complement the significant efforts by many jurisdictions in further strengthening their own local requirements.

In Europe, Solvency II is driving further prudential regulatory harmonisation. This could eventually be extended to non-EU countries as a result of the increased emphasis on group supervision and the concept of 'equivalence' which is part of the debate in our [Europe Perspective](#). In addition, Europe plans to introduce greater harmonisation of conduct of business regulation which has a direct impact on [Customer treatment](#). Two new directives (Packaged Retail Investment Product Services directive and the Insurance Mediation Directive 2) are in development with anticipated implementation dates following the introduction of Solvency II in 2013.

The US has commenced its own reforms with the Solvency Modernisation initiative (SMI); such developments are more aligned to the IAIS's new Insurance Core Principles concerning solvency and group supervision mechanisms outlined in the [Americas Perspective](#). In Asia Pacific, an area of significant focus for inward investment by many international insurance groups, regulators are very much aware of developments in risk and capital management in Europe and by the IAIS; and as examined in our [ASPAC Perspective](#), most have already effected or are considering significant change.

Despite the IAIS developments of general convergence and the current lack of a formal global mandate in insurance regulation, the diversity of local markets means that regulators' approaches will still be localised. Over time we expect to see a greater uniformity in regulatory approach to capital, risk and governance arrangements in global markets, as internationally active insurance groups develop their presence in emerging markets.

This report highlights the major changes already agreed in solvency standards, governance and supervision – particularly group supervision. We also examine the current debate concerning [Systemic risk](#), the new regulatory common framework now being created for internationally active insurance groups and the likely impact this may have for insurance groups world-wide.

The regulatory developments set to take place across the global industry over the coming years represent an unprecedented and fundamental change in the approach to regulation. The impact will extend beyond mere compliance changes and will strike at the heart of the business agenda. The requirement for the creation of shareholder value will mean insurers have to revise their business models, reassessing where capital is deployed, in which geographic markets and product lines to operate, and how best to redesign their products to take account of new capital requirements. New risk transfer mechanisms and financing structures will emerge, as well as new distribution models with evolving

conduct of business regulation. These developments will increasingly force insurers to re-evaluate which parts of the value chain to focus on. Furthermore, merger and acquisition activity looks set to increase as insurers seek to modify their portfolios as well as acquire key skills.

As group supervision gathers pace, it is causing insurance groups to review their operating models, to enable a consistent approach to risk and capital management across the group and enhance the quality and timeliness of business decision-making. Approaches to the use of internal models are evolving and this will continue for some time, as will the need for cultural change to enable insurers to optimise through effecting more dynamic approaches.

Many international groups (in Europe in particular, as a consequence of Solvency II) are already considering, if not yet implementing, large scale strategic structuring and organisational change programmes. This is taking the form of the creation of 'supercarriers' (the use of branch structures) to realise capital diversification benefits that may not be tangible at group level, reviewing capital structures and simplifying and ring-fencing regional sub-groups to manage group risk to local entities. A key aim of the current structural change is to mitigate the extent to which the global group has to deal with multiple supervisors' requests for information as they introduce group supervision – this makes the IAIS's proposals for a common framework for international groups particularly attractive.

It is not only regulators who are setting the agenda, rating agencies and analysts will inevitably also play a role in influencing the outcomes. This will be reinforced through the increased emphasis on transparency and disclosure that fundamentally underpins the regulatory change and puts regulation increasingly high on the competitive agenda.

Regulation is clearly on the move on many levels and the challenge has been laid down to the sector as a whole. For many insurers these changes are now beginning to rank more highly on the strategic agenda, and those firms that embrace the change within the business will inevitably reap the rewards in years to come.



The International Association of Insurance Supervisors (IAIS)

A new global framework

The IAIS was established in 1994 with the broad aim of harmonising international insurance regulatory requirements. It acts as a forum for insurance supervisors to discuss developments in the insurance sector and topics affecting insurance regulation. The IAIS has now grown to represent 190 insurance supervisory jurisdictions and is the world standard setter for insurance.

Since 1999, insurance professionals comprising industry associations, insurers and reinsurers, consultants, professional associations and international financial institutions have been able to join the IAIS as observers. The IAIS currently has more than 120 observers.

As an international standard setter, the IAIS issues insurance principles, standards and guidance papers, which apply to all member supervisory authorities. The IAIS also works closely with other standard setters, notably:

- The Basel Committee on Banking Supervision (BCBS)
- European Insurance and Occupational Pensions Authority (EIOPA)
- European Commission, insurance area
- Financial Stability Board (FSB)
- International Accounting Standards Board (IASB)
- International Actuarial Association
- International Monetary Fund (IMF)
- International Organisation of Securities Commissions (IOSCO)
- Organisation for Economic Cooperation and Development (OECD)
- The Joint Forum
- The World Bank

The IAIS also provides its members with training and support on issues related to insurance supervision, and organises meetings and seminars for insurance supervisors.

The significance of the IAIS and FSAP process

The IAIS principles, standards and guidance apply to individual insurance supervisors who are members of the IAIS. National regulators are expected to implement the Insurance Core Principles (ICPs) produced by the IAIS. The new ICPs, which become effective in October 2011, apply to insurance legal entities and insurance groups unless otherwise stated. While they do not apply to non-insurance entities (regulated or unregulated) within an insurance group, they will apply to insurance legal entities and insurance groups with regard to the risks posed to them by non-insurance entities.

The new suite of IAIS solvency standards essentially requires supervisory regimes world-wide to establish risk-based solvency requirements. These standards reflect a total balance sheet approach on an economic basis, which address all reasonably foreseeable and relevant material risks.

Even though the IAIS standards, through the ICPs, currently take the form of high-level principles-based requirements, they nonetheless require all supervisors to enact the requirements into their local supervisory frameworks. If they do not they risk receiving an adverse finding from the IMF/World Bank who conduct the Financial Sector Assessment Programme (FSAP) reviews.

The new suite of IAIS solvency standards essentially requires supervisory regimes world-wide to establish risk-based solvency requirements.



01

Capital adequacy including internal models

Raising standards

Risk-based solvency regimes for insurers have existed since the 1990s, with examples currently found in North America, parts of Europe, Australia, and several other Asia Pacific countries. From 2013, the European Union (EU) will implement a harmonised risk-based capital framework (Solvency II) across the European Economic Area (EEA), while Switzerland, Bermuda, South Africa and Mexico are also in the process of modernising their solvency frameworks along similar lines.

Capital adequacy

However, risk-based capital regimes differ greatly between countries. Historically they have been mostly factor-based, and factors often do not vary by company, although some vary by volume of business or level of asset concentration. When setting an insurer's solvency capital requirements, risk-based capital regimes typically measure asset risk, insurance risk, and business risk. Recently, many risk-based capital regimes have increased the scope of risks considered when setting capital to include credit risk, market risk and operational risks.

In addition to these capital requirements, many regulatory frameworks are beginning to include an enhanced Enterprise Risk Management (ERM) framework that considers the

organisational structure of risk management, governance, reporting, disclosure and transparency requirements, as well as considerations for group risks. Increasingly risk-based capital regimes are also employing scenario and stress testing requirements.

In Europe, the Solvency II programme will fundamentally change the capital adequacy requirements. Insurers will need to demonstrate that they have adequate financial resources which reflect key quantitative requirements, such as own funds (capital), technical provisions and the methods for calculating the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The most significant is the SCR which aims to be set at a level where eligible own funds will enable insurers to absorb losses to a confidence level of 99.5 percent over a one year period – equivalent to a one in a 200-year event.

The estimated impact of Solvency II on European insurers ranges from €3.5–€4bn (US\$4.8bn–\$5.5bn). This includes the cost to firms of undertaking substantial risk, capital and governance change programmes, and the need to undertake capital remediation measures as a result of supervisory assessments.

However, at an international level, unlike banking, there is no agreed capital adequacy standard amongst jurisdictions. Each regulator has created its own local capital requirements. As many of these requirements are historically based, there is usually no confidence level or time horizon on which the capital requirements are based. It has also meant that there is no consistency in the structure of capital requirements or the view on the adequacy of capital resources for insurers at an international level – until now.

The new IAIS standard on capital adequacy, which becomes effective in October, begins to bring international capital adequacy standards together.

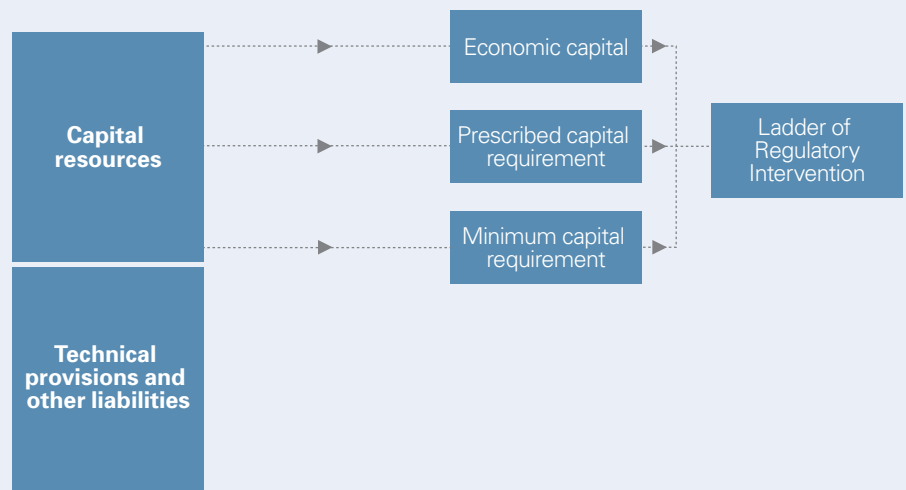
The standard requires all solvency regimes to establish regulatory capital requirements at a level sufficient to ensure that, in adversity, an insurer's obligations to policyholders will continue to be met as they fall due. It requires that insurers maintain capital resources to meet the regulatory capital requirements. The standard also introduces solvency control levels which are designed to trigger different degrees of intervention by supervisors.

In the context of insurance legal entity capital adequacy assessment, the IAIS advocates that regulatory authorities define regulatory capital requirements that establish a solvency control level above which the supervisor does not intervene on capital adequacy grounds. The IAIS describes this intervention level as the Prescribed Capital Requirement (PCR). This is analogous to the SCR in Solvency II. The PCR is defined such that assets will exceed technical provisions and other liabilities with a specified level of safety over a defined time horizon. The other intervention level is a solvency control level at which, if breached, the

supervisor would invoke its strongest actions, in the absence of appropriate corrective actions by the insurance legal entity. This is referred to as the MCR. The MCR is subject to a minimum bound, below which no insurer is regarded to be viable to operate effectively. The interplay between the new capital requirements and supervisory ladder of intervention can be seen in [Diagram 1](#).

Significantly, the IAIS standard now requires all jurisdictions to set out appropriate target criteria for the calculation of regulatory capital requirements which underlie the calibration of a standardised approach. This means that major insurance markets such as the US and Japan are now moving to define such levels. Solvency II has determined its desired confidence level as 99.5 percent over a one year time horizon for the SCR. The IAIS standard also requires jurisdictions to set criteria for the assessment of the quality and suitability of capital resources, having regard to their ability to absorb losses on both a going-concern and wind-up basis.

Diagram 1: Capital requirements and supervisory intervention



Source: KPMG International, February 2011.

In the context of group-wide capital adequacy assessment, the capital adequacy standard is less specific. Rather than requiring a PCR and MCR, as it does in the context of insurance legal entity capital adequacy assessment, it requires that regulatory requirements establish solvency control levels that are appropriate in the context of the approach to group-wide capital adequacy that is applied.

Regulators are also increasingly turning their attention to the quality of capital available to meet insurance liabilities and other commitments. The capacity of insurers to absorb losses on both a going-concern and wind-up basis will become more important, increasing the need to have adequate scenario modelling capabilities.

ASPAC

Even though insurers in Asia generally weathered the global financial crisis well, the experience of the past two years has demonstrated the need for regulation to keep pace and anticipate innovation in financial services.

Across Asia there is a clear trend towards a more risk-based approach to insurance supervision, with risk-based capital frameworks in Australia, Japan, Taiwan, Singapore, Malaysia and Korea.

Notable developments also include the China Insurance Regulatory Commission (CIRC) risk management circular, which was updated in 2008 to require the establishment of a risk-based solvency monitoring framework. China also introduced regulation in October 2010, which is expected to significantly enhance the alignment of the management of insurance business in a much more risk-centric way, and points to the use of economic capital as the key risk measurement tool.

The Australian regulator, the Australian Prudential Regulation Authority (APRA) has in many ways been at the forefront of change in the region with its aims of achieving a more risk-sensitive capital framework that also aligns capital requirements for general and life insurers. The collapse of HIH Insurance in 2001, the country's second largest non-life (general) insurer, was the catalyst for prudential capital reform in the general insurance industry. The Australian risk-based framework performed well during the global financial crisis, although the capital base of some life insurers was negatively impacted by falls in the equity markets.

North America

In June 2008 prior to the global financial crisis (GFC) the US launched the Solvency Modernization Initiative (SMI). This sought to further enhance the existing risk-based capital (RBC) regime. Challenged by other global solvency reforms such as Solvency II and Basel III in banking, the NAIC (National Association of Insurance Commissioners) and the insurance industry took the opportunity to consider a more risk-based approach to insurance solvency regulation. It is understood that these measures may lead to insurers being required to hold different levels of capital.

The NAIC has stated that SMI is not a US implementation of Solvency II. In many ways RBC is more akin to a standard formula approach. Where existing factors are inappropriate for a specific risk on some products, the NAIC may allow modelling approaches to substitute the specific risk factors concerned.

Regulators are also increasingly turning their attention to the quality of capital available to meet insurance liabilities and other commitments.

What are the implications?

- The introduction of solvency control levels will formalise the existing practice in many countries by having targeted regulatory capital levels. These will become a hard target, over and above the stated regulatory minimum requirements. Such formalised arrangements could mean that the supervisors set a new informal target above this new higher minimum level. This could have capital management implications for many insurers.
- By setting new PCR, it is most likely that insurers will want to set new minimum targets for themselves above this new threshold level. This will probably result in opportunity cost implications for many insurers.
- The introduction of specified levels of safety over a defined time horizon means insurers will now need to begin contemplating whether to have a capital management framework that can model economic capital requirements.

Internal models

Another major development is that the IAIS capital adequacy standard includes general provisions on the use of an internal model to determine regulatory capital requirements (where this is allowed by the supervisor). This is a major step forward world-wide in the supervisory arena. The IAIS has made clear that, where a solvency regime allows the use of internal models to determine regulatory capital requirements, the solvency regime should establish appropriate modelling criteria to be used for the determination of regulatory capital requirements. For example, an insurer is required to adopt risk modelling techniques and approaches appropriate to the nature, scale and complexity of its current risks and those incorporated within its risk strategy and business objectives in constructing its internal models for regulatory capital purposes. Further, insurers will need to validate their internal models by subjecting them to, as a minimum, the following three tests: a statistical quality test, a calibration test and a use test.

The *statistical quality test* requires insurers to assess the base quantitative methodology of the internal model, to demonstrate the appropriateness of this methodology, including the choice of model inputs and parameters, and to justify the assumptions underlying the model. It also requires that the determination of the regulatory capital requirement using an internal model addresses the overall risk position of the insurer and that the underlying data used in the model is accurate and complete.

The *calibration test* requires the insurer to demonstrate that the regulatory capital requirement determined by the internal model satisfies the specified modelling criteria as established by the supervisory jurisdiction. Importantly, the *use test* requires the insurer to fully embed the internal model, its methodologies and results, into the insurer's risk strategy and operational processes.

The use test can require significant cultural and potentially organisational change and will be critical for insurers to get right, as shown by the experience of banks. The Board and senior management must have overall control of, and responsibility for, the construction and use of the internal model for risk management purposes, and ensure sufficient understanding of the model's construction at appropriate levels within the insurer's organisational structure. In particular, the IAIS standard requires that the insurer's Board and senior management understand the consequences of the internal model's outputs and limitations for risk and capital management decisions. Insurers will also be expected to have adequate governance and internal controls in place with respect to the internal model.

The IAIS standard further requires the insurer to document the design, construction, and governance of the internal model, including an outline of the rationale and assumptions underlying its methodology. Supervisors will be expected to require documentation to be sufficient to demonstrate compliance with the three tests for internal models outlined above.

The insurer will also be expected to properly document internal model changes and report information necessary for supervisory review and ongoing approval of the internal model on a regular basis.

What are the implications?

- It is expected that many supervisory regimes will begin to allow internal models to be used to determine regulatory capital requirements, subject to rigorous criteria. These changes are likely to present as many challenges for insurers as they do opportunities. Initial preparatory work with local regulators will be key in the roll-out of such reforms.
- The statistical quality test, calibration test and use test are expected to be demanding. Insurers should begin to examine whether their data set and system capabilities are adequate and appropriate.
- Defining model parameters, inputs and underlying assumptions are usually very demanding for most insurers. Early identification and planning of such analysis will provide organisational benefits given the associated risk and governance inputs required.

Insurers will also be expected to have in place ongoing validation and supervisory approval of the internal model. The insurer will be expected to monitor the performance of its internal model and regularly review and validate the ongoing appropriateness of the model's specifications. Importantly, the insurer will be required to demonstrate that the model remains fit for regulatory capital purposes in changing circumstances against the criteria of the statistical quality test, calibration test and use test. The insurer will be required to notify the supervisor of material changes to the internal model made by it for review. Continued approval of the use of the model for regulatory capital purposes will also be required. The insurer will also be expected to properly document internal model changes and report information necessary for supervisory review and ongoing approval of the internal model on a regular basis. The information expected will include details of how the model is embedded within the insurer's governance, operational processes and risk management strategy, as well as information on the risks assessed by the model and the capital assessment derived from its operation.

ASPAC

In general, we expect the ASPAC insurance industry to see significant development in the use of internal economic capital models. This is not to say that the region lags in the development of models – because we see a number of companies across ASPAC with sophisticated risk quantification frameworks. However this may be challenging for certain domestic insurers and for smaller players.

Europe

European insurers under Solvency II have much to gain from the internal model use test requirements as described above, where senior management must essentially demonstrate the use of internal model output in the decision-making process, such as to support M&A activity, investment decisions and reinsurance buying. Regulation in ASPAC is expected to follow suit by making the internal or economic capital model the key risk management tool. Significant investment is required however – particularly at senior management level and in developing risk reporting lines – to fully realise the benefits that additional risk information can provide, both in setting strategy and in day-to-day management decisions.

North America

Due to the financial data collected and the subsequent examination process undertaken by US supervisors, many remain to be convinced of the benefit of internal models in setting regulatory capital requirements. The move to a full internal model approach to solvency is therefore receiving a much more cautious approach. While some modelling is undertaken on certain products, the US is wary of over-reliance on internal models and will most likely wait until Europe has fully operationalised Solvency II to gauge the success of such reforms.

Issues to consider

While insurers do not have an internationally recognised capital framework comparable to the Basel Accord, the changing regulatory landscape will begin to pose new challenges for many in the insurance industry:

- Have you thought about the impact capital management changes will have on your business, particularly in regards to:
 - Existing business
 - New business
 - Pricing models
 - Capital planning and management
 - Data and systems needed for robust real time measurement
 - Business to grow, divest, restructure
 - Targets to meet new requirements?
- Do you have the planning and project management capabilities to bring together the necessary interactions and linkages between Pillar I (regulatory capital), Pillar II (own assessment) and Pillar III (reporting)?
- Are your Board and senior management sufficiently focused on the changing regulatory landscape to maximise competitive advantages that may be derived from utilising advanced risk and capital management techniques?
- For subsidiaries of groups, the interplay of capital adequacy at the local level and how such arrangements can best be incorporated at the group level to maximise economic efficiencies will likely require greater focus. How well prepared are you to meet these new demands?
- Early engagement with supervisors is critical in establishing and building relationships and establishing the necessary awareness and understanding of your needs. How well does your supervisor understand your business?

Significant investment is required however – particularly at senior management level and in developing risk reporting lines – to fully realise the benefits that additional risk information can provide, both in setting strategy and in day-to-day management decisions.

Perspectives: ASPAC

Diversity and progress

Insurance business in Asia Pacific is booming. Life and non-life insurance penetration rates for the region as a whole remain low and so there is significant room for ongoing growth. In fact, for much of the region in recent decades, the story has been one of growing the market rather than competing for market share. Coupled with the relatively quick emergence of Asian economies from the global financial crisis (GFC), this region is attracting significant attention from local and global players alike.

Similar to the banking industry as discussed in *Evolving Banking Regulation*¹, a common question is, is the focus on developing more sophisticated capital adequacy and Enterprise Risk Management (ERM) warranted, given that players in the region emerged from the GFC with stronger balance sheets compared to their peers in Europe and the US? I believe that it would be very short-sighted to take such a view, because there are many lessons that ASPAC insurers can learn from their counterparts in Europe and the US – perhaps most importantly that enhancements in risk management can assist profitable growth, rather than acting as a barrier to growth as is sometimes perceived.

Of course, the region is diverse. There are significant differences in both the characteristics of the insurance sector, and the sophistication of regulation in each jurisdiction. The jurisdiction-specific model of insurance regulation – which we expect to endure in ASPAC for the foreseeable future – has implications for group-wide financial reporting and capital management. In the twenty-first century of increasing connectivity, regulation and management of systemically important financial institutions (SIFIs) is, in many ways, constrained by a country-by-country approach.

The two key areas of significant development that are expected to shape the industry in the years to come are: risk and capital management, and the impact of global developments in financial reporting by insurers.

Risk and capital management

One of the lessons learned from the GFC is that prudential supervision in some countries can be a blunt tool. Because some solvency capital regimes are not very sensitive to risk, they arguably compensate through excessive prudence. This can be a poor trade off, however – higher capital requirements are not the solution to all risks. For this reason, we are seeing a move to more risk-based capital regimes post GFC.

In my experience, regulators in the region have been watching the IAIS and Solvency II developments with much interest, and will continue to do so before undertaking major reforms to their own prudential frameworks. However, risk-based solvency capital (RBC) regimes for insurers have existed in the region for many years. The Australian regulator recently has been very active, and is currently reviewing its capital standards; the Japanese, Korean and Taiwanese solvency capital RBC regimes are not dissimilar to the current US RBC solvency capital model; and the Singaporean and Malaysian RBC regimes are, in fact, considerably more granular than RBC regimes of other jurisdictions. Now that ERM and solvency capital standards have been approved in Europe for Solvency II and internationally via the IAIS, I believe that many jurisdictions will pick up the pace of change. This is particularly relevant when considering the Financial Sector Assessment Program (FSAP) reviews conducted by the IMF and World Bank.

Being able to study Solvency II implementation developments and

Regulators in the region have been watching the IAIS and Solvency II developments with much interest, and will continue to do so before undertaking major reforms to their own prudential frameworks.



challenges in Europe is clearly an advantage to the industry in ASPAC, and lessons can be learned both in terms of what to do, as well as what not to do.

Financial reporting

The second area attracting a lot of attention is the ongoing developments in financial reporting, which we discuss in detail in chapter 3 ([Accounting, valuation and disclosure](#)). In ASPAC, unlike Europe, where IFRS is frequently only adopted at Group level, local statutory reporting is often IFRS-based and already impacts small and large insurers alike. Australia, Hong Kong, Singapore and Malaysia for example have already adopted models that at the very least closely model IFRS, with changes made to suit country-specific legislation or contexts. IFRS adoption in Korea from 2011, and for some international Japanese companies from 2010 onwards, will increase the significance of IFRS in the region.

Existing statutory liability measurement rules in jurisdictions including Australia, Hong Kong, Singapore and Malaysia already allow or even mandate discounting for non-life business and the application of risk margins. A key step for regulators and the industry at large in these jurisdictions will be in harmonizing (or otherwise) the existing statutory measurement rules with those of the IASB's Insurance Contracts standard when it is issued. One of the key activities for ASPAC insurers over the coming 12 months

is to navigate a path through these forthcoming accounting measurement changes, while continuing to meet the challenges of a fast moving business environment. How insurers respond will help to shape the future of business reporting, as it evolves beyond compliance to communicate the value that they are generating for their stakeholders.

I believe that the regulatory changes in financial reporting and capital management – which I expect to result in greater standardisation and harmonisation of how insurers manage their business and communicate to their various stakeholders – may well begin to standardise products and will result in greater consolidation in the region. The region is set for exciting and challenging times ahead.



Martin Noble
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One of the key activities for ASPAC insurers over the coming 12 months is to navigate a path through these forthcoming accounting measurement changes, while continuing to meet the challenges of a fast moving business environment.

1. *Evolving Banking Regulation: A marathon or a sprint?*
KPMG International, November 2010.

02



ORSA-ERM revisited

Increasing protection

Across all sectors, risk management has received significant attention. Industry efforts in this regard have been, and continue to be, considerable. Of all the new IAIS standards, ERM is the most significant. The standard now requires supervisors to seek high standards of risk management and governance from insurers and, critically, supervisors are being encouraged to challenge the insurers they regulate on risk management issues. In particular, the IAIS standard requires an Own Risk and Solvency Assessment (ORSA) under which an insurer undertakes its own forward looking self assessment of its risks, corresponding capital requirements and adequacy of capital resources.

For the first time, world-wide supervisory regimes will now be expected to require from insurers an ERM framework that provides for the identification and quantification of risk. It must be under a sufficiently wide range of outcomes using techniques that are appropriate to the nature, scale and complexity of the risks the insurer bears and adequate for risk and capital management for solvency purposes. The insurer’s measurement of risk will need to be supported by accurate documentation providing appropriately detailed descriptions and explanations of the risks covered, the measurement approaches used and the key assumptions made.

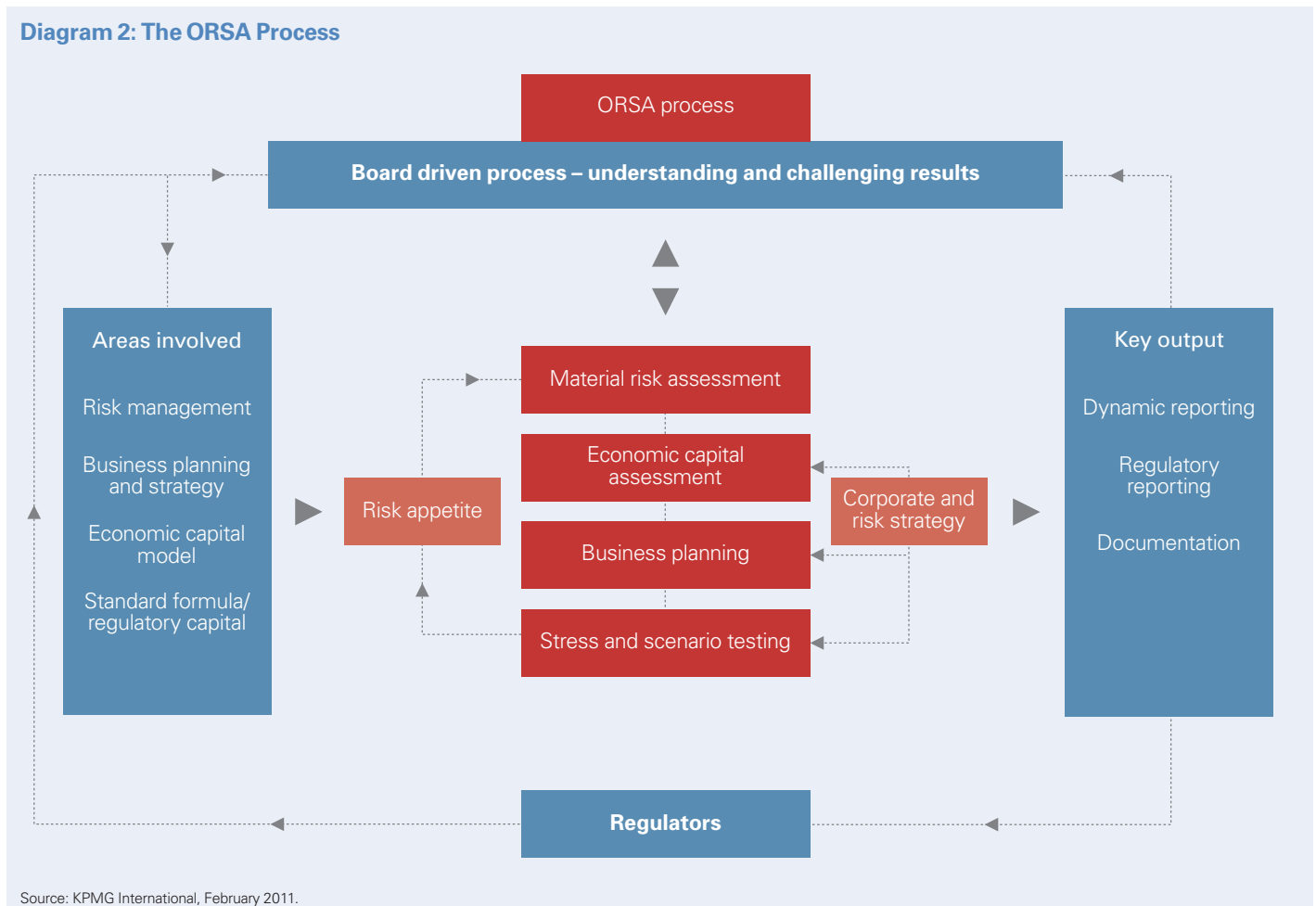
In delivering the ORSA, firms will need to go further than current practice to deliver a process fit for the business and regulatory purposes. The functions involved in the process will feed into the ORSA at different stages of its

development; they will be responsible for developing content, reviewing the inputs of others and considering outputs related to their areas as shown in **Diagram 2**.

Specifically, the insurer will be required to have a risk management policy which outlines how all relevant and material categories of risk are managed, both in the insurer’s business strategy and in its day-to-day operations. The risk management policy will be expected to describe the relationship between the insurer’s tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk. The risk management policy will also need to include an explicit Asset-Liability Management (ALM) policy which clearly specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.

In delivering the ORSA, firms will need to go further than current practice to deliver a process fit for the business and regulatory purposes.

Diagram 2: The ORSA Process



Source: KPMG International, February 2011.

Insurers will be required to have a risk management policy that is reflected in an explicit investment policy, which specifies the nature, role and extent of the insurer's investment activities and outlines how the insurer complies with the regulatory investment requirements established by its regulator. Further, the insurer will need to demonstrate how it has established explicit risk management procedures within its investment policy; particularly relating to more complex and less transparent classes of assets, its investment in markets or instruments that are subject to lighter governance or regulation, including explicit policies in relation to underwriting risk.

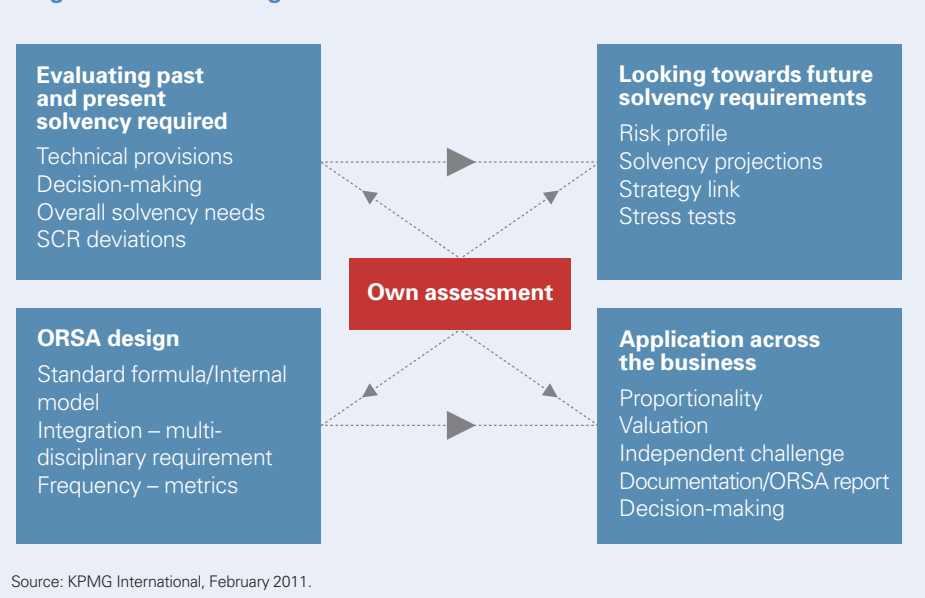
The IAIS ERM standard will also require insurers to establish and maintain a risk tolerance statement which sets out its overall quantitative and qualitative risk tolerance levels. It defines tolerance limits that take into account all relevant and material categories of risk and the relationship between them; to make use of its risk tolerance levels in its business strategy; and embed its defined risk tolerance limits in its day-to-day operations via its risk management policies and procedures.

There is also a requirement that the insurer's ERM framework is responsive to changes in its risk profile. By incorporating a feedback loop, based on good quality information, management processes and objective assessment, to enable the insurer to take the necessary action in a timely manner in response to changes in its risk profile.

ORSA

Perhaps the most significant feature of the IAIS ERM standard is the requirement for an insurer to regularly perform an ORSA to assess the adequacy of its risk management and current, and likely future, solvency position.

Diagram 3: ORSA Design



An ORSA is a bespoke strategic analysis process which links together the outputs of risk, capital and strategic planning, to determine the current and future capital requirements of the firm, based on the business strategy and external environment.

In essence the ORSA should outline the clear relationship between a number of key business processes as illustrated in **Diagram 3**.

ORSA Design

There is currently no single approach to designing an ORSA and this reflects the intent by regulators who have been deliberate in not providing prescription, in order to keep this very much a firm's 'own' assessment. That in itself provides significant implementation challenges for insurers.

An ORSA must demonstrate how the insurer's strategy and risk management links with its management of capital (economic and regulatory) and the relationship between the insurer's

There is currently no single approach to designing an ORSA and this reflects the intent by regulators who have been deliberate in not providing prescription.

tolerance limits and processes and methods for monitoring risk. Key to this process is demonstrating the linkages between corporate governance and Board responsibilities, economic capital, ERM and business and strategic planning processes.

At its heart, the ORSA will require input from key stakeholders, which will require multidisciplinary teams working closely together to deliver the ORSA. As a minimum, this should include: risk, finance, strategy, actuarial, audit, compliance, and human resource and treasury operations.

Increased Board and senior management responsibilities

The insurer's Board and senior management must be responsible for the ORSA and encompass all reasonably foreseeable and relevant material risks. The minimum requirements include underwriting, credit, market, operational and liquidity risks and additional risks arising due to membership of a group. Where a risk is not readily quantifiable, for instance some operational risks, or where there is an impact on the insurer's reputation, an insurer should make a qualitative assessment that is appropriate to that risk and sufficiently detailed to be useful for risk management. The assessment is required to identify the relationship between risk management and the level and quality of financial resources needed and available.

What are the implications?

- The Board and senior management will need to demonstrate that they have conducted their own review of the risks to which they are exposed and to assess their own solvency needs. They will need to demonstrate that the ORSA is an integral part of managing the business against the company's chosen strategy and that it is used in assisting strategic decision-making. The ultimate success of an ORSA is in being able to demonstrate a thorough integration of the process and outputs within business as usual activities such as Board oversight and responsibilities, strategic planning, risk and capital management, governance and internal controls and reporting and disclosure elements.
- Data and system issues are likely to present significant challenges. The ORSA will need to rely on robust risk metrics and information particularly for performing capital (Pillar 1) calculations. This will become even more important where no internal model exists. Bringing together these inputs will require a clear and well articulated programme plan in order to obtain key stakeholder buy-in and support.
- Failing to appropriately manage the various cultural perspectives or appreciate the differences in approach, input and emphasis amongst business units and group entities is a considerable weakness of many large ORSA programmes.
- Identification of key resources and specific skill sets across all relevant business units will be required in order to ensure successful delivery of the technical necessary input and that appropriate personnel are fully engaged.
- Given the ORSA inputs will come from a multitude of stakeholders and the outputs will be in varied formats, ensuring appropriate and timely management information is critical in providing a firm with the ability to report adequately on its current status.
- The requirement to evidence the ORSA will make documentation extremely important particularly for external reporting purposes.
- It is expected that the rating agency community will utilise the ORSA report to provide them with a single source of information conveying the regulatory and internal management view as to the financial strengths of the firm and the sophistication of its risk management. It is therefore essential that insurers aim to capture all the risk management processes within their organisation in order to convey the most compelling evidence for external purposes.

The insurer will be expected to apply reverse stress testing to identify scenarios that would be the likely cause of business failure... and the actions necessary to manage this risk.

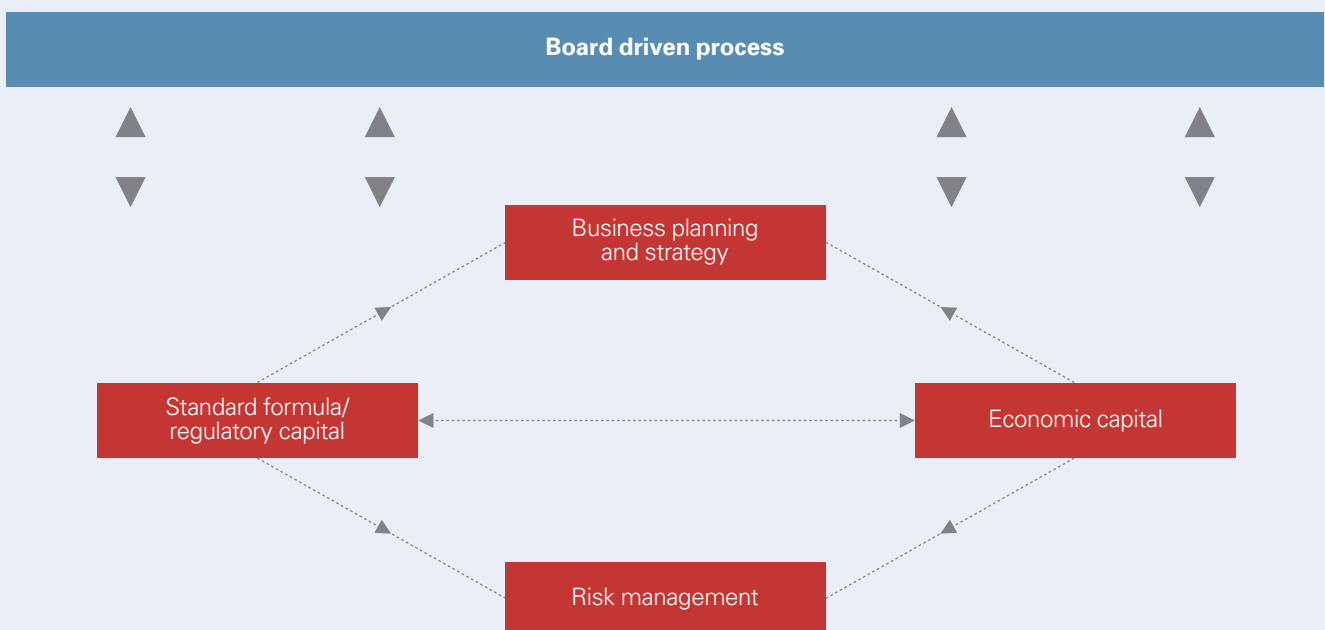
Capital considerations

Importantly, with regard to economic and regulatory capital, an insurer will be required to determine, the overall financial resources it needs to manage its business given its own risk tolerance and business plans, and to demonstrate that supervisory requirements are met. It must base its risk management actions on consideration of its economic capital, regulatory capital requirements and financial resources, including its ORSA and assess the quality and adequacy of its capital resources to meet regulatory capital requirements and any additional capital needs.

Increased modelling capabilities and sophistication required

The insurer will be required, as part of its ORSA, to analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than has previously typically been used to determine regulatory capital requirements. In carrying out its continuity analysis, the insurer will be expected to apply reverse stress testing to identify scenarios that would be the likely cause of business failure (e.g. where business would become unviable or the market would lose confidence in it) and the actions necessary to manage this risk.

Diagram 4: Board driven process



Source: KPMG International, February 2011.

An insurer's continuity analysis will be expected to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements. The insurer's continuity analysis may, for example, include projections over three to five years (or another period appropriate to the insurer's business) even where regulatory capital requirements are typically determined over a one year time horizon.

Strengthened supervisory oversight

Supervisors will be expected to undertake reviews of an insurer's risk management processes and its financial condition, including the ORSA. Where necessary, the supervisor will be able to require strengthening of the insurer's risk management, solvency assessment and capital management processes. In undertaking its ORSA, the insurer will be required to consider the extent to which the regulatory capital requirements (in particular, any standardised formula) adequately reflect its particular risk profile. In this regard, the ORSA undertaken by an insurer will be a key source of information to the supervisor in reviewing the adequacy of the regulatory capital requirements of the insurer and in assessing the need for variation in those requirements.

Where necessary, the supervisor will be able to require strengthening of the insurer's risk management, solvency assessment and capital management processes.

ASPAC

None of the above will be surprising to regulators or insurers in the ASPAC region, where the principles of ERM are well understood, if not yet embedded in current regulations. There is clear appreciation amongst regulators across the region that sound risk management is fundamental to healthy development and growth of the industry, and this is an area of focus for many.

North America

Despite the risk-focused examination process undertaken in the US, the adoption of an ORSA tool to complement these reviews is under consideration by a task force supporting the NAIC's Solvency Modernization Initiative. The use of an ORSA and its contents need to be defined together with a clear understanding of its purpose and how it fits alongside other tools that may be in place such as an ERM framework. A key challenge will be the principle-based nature of an ORSA – that its form will be different for each insurer, and there is a need to for regulators and insurers alike to understand how an ORSA can be implemented in a proportional way. There are industry concerns about the confidential information that is contained within an ORSA. At the NAIC conference in October 2010, after a period of consultation, it was decided to push ahead with the development of an ORSA tool.

Issues to consider

- Will your ORSA be a real business tool that can be used to drive business strategy and decision making at both a Group and Solo level?
- Is your organisation able to bring together all aspects of the business and the activities it undertakes so the risk and capital implications can be assessed in the aggregate?
- Are your processes consistently embedded and managed across the business or Group to ensure delivery and integration of the ORSA?
- The ORSA is required to be forward-looking considering future capital needs, while taking into account past performance and lessons learnt. How capable would your firm be in undertaking an ORSA now?
- Is your organisation able to demonstrate continuous compliance with the regulatory capital and technical provisions requirements?
- Are your stress and scenario analysis capabilities able to fully capture and evidence adequate capital and risk understanding?

03



Accounting, valuation and disclosure

Aiming for convergence...

There has been considerable debate world-wide concerning International Financial Reporting Standards (IFRS) developments by the International Accounting Standards Board (IASB), particularly in regards to the valuation and measurement of insurance contracts.

Comments on the IASB exposure draft (ED) on insurance contracts closed 30 November 2010, and the responses are discussed in the January 2011 IFRS Insurance newsletter². While the IASB is still striving for a final standard for this year, this heralds a potential step-change in international insurance accounting – holding out the encouraging prospect of converged world-wide accounting and reporting requirements for insurance contracts. The aim is to improve comparability, provide for greater transparency of insurers' financial statements (which are often criticised for being opaque) and reduce inconsistencies in insurance financial reporting.

The ED's approach to measuring insurance contracts is based on four 'building blocks'.

The first building block is an explicit, unbiased and probability-weighted estimate (i.e. expected value) of future cash flows that will arise as the insurer fulfils the insurance contract.

The second building block proposed is an adjustment of the future cash flows for the time value of money, using discount rates that:

- are consistent with observable current market prices for instruments whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency and liquidity; and
- exclude any factors that influence the observed rates but are not relevant to the insurance contract liability.

The third building block is an explicit risk adjustment representing the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected, determined using one of three calculation techniques permitted by the ED.

Finally, the fourth building block is a residual margin, which eliminates any gain at inception and is 'locked-in' (i.e. not re-measured) and amortised over the coverage period on the basis of the passage of time, or the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time. If blocks one to three would result in a loss at inception, that loss is recognised in the income statement immediately and no residual margin is required.

ASPAC

As Martin Noble discusses in the [ASPAC Perspective](#) on page 14, local statutory reporting in ASPAC is often IFRS-based and already impacts small and large insurers alike. APRA in Australia is considering changes to the recognition, valuation and measurement of insurance contracts following the IASB's ED, as part of the IFRS project. China has also recently introduced significant changes to insurance financial reporting which pre-dated the ED, but are generally consistent with it.

A source of contention for many insurers is the term structure to be used to discount future cash flows. ASPAC insurers may find calibrating assumptions relating to the risk free rate and liquidity premium proposed by the ED challenging in markets where local debt markets are not deep and liquid and swap markets limited.

North America

In the US, Statutory Accounting Principles (SAP), via statutory reporting, remains the main focus for many insurers even with the joint project now underway between the IASB and FASB regarding insurance contracts. The IASB has issued an exposure draft and FASB a discussion paper on this subject. The timeline for completion of the exposure draft and discussion paper is not known. There are divergences in a number of areas, but also similarity, a debate highlighted from the G20 Summit in Seoul³. The principal area where there is a divergence is in the number of the building blocks, with the FASB using three building blocks, combining the concepts underpinning the risk margin and residual margin into

a single composite margin. IFRS adoption in the US is still being considered but it is clear that any such decisions will have significant implications for US insurers.

A source of contention for many insurers is the term structure to be used to discount future cash flows.

2. "Analysis of responses to the insurance proposals", *IFRS Insurance Newsletter*, KPMG IFRG Limited, January 2011.

3. *Convergence on the agenda, but divergence on the cards? Developments from the G20 Summit in Seoul*, KPMG International, November 2010.

IAIS valuation

The IAIS has been undertaking its own work on the valuation of assets and liabilities, including technical provisions, for solvency purposes. Development of this standard and guidance paper has proven to be one of the most difficult for IAIS members given the regional differences that apply to regulatory accounting and reporting requirements.

Despite these issues, the IAIS standard will be constructed such that it is very aligned with the IASB's proposals; a key over-riding aim of the IAIS is to ensure that the methodologies used in calculating items for general purpose financial reports can be used for regulatory reporting purposes as far as possible. This will limit changes to a minimum, so that regulatory reporting does not diverge unless absolutely necessary.

A key feature of the IAIS deliberations has been around how the valuation of assets and liabilities for solvency purposes needs to take account of a total balance sheet approach to solvency assessment and the interplay between available capital resources and required regulatory capital. At the same time, it is recognised that there may be differences between accounting and regulatory standards regarding the valuation of assets and liabilities for general purpose financial reporting.

The IAIS valuation standard is expected to cover both measurement and reporting requirements:

- The valuation addresses recognition, derecognition and measurement of assets and liabilities;
- The valuation of assets and of liabilities is undertaken on consistent bases;
- The valuation of assets and liabilities is undertaken in a reliable, decision useful and transparent manner;
- The valuation of assets and liabilities is an economic valuation;
- An economic valuation of assets and liabilities reflects the risk-adjusted present values of their cash flows;
- The value of technical provisions and other liabilities does not reflect the insurer's own credit standing;
- The valuation of technical provisions exceed the Current Estimate by a margin (Margin Over the Current Estimate or MOCE);
- The Current Estimate reflects the expected present value of all relevant future cash flows that arise in fulfilling insurance obligations, using unbiased, current assumptions;
- The MOCE reflects the inherent uncertainty related to all relevant future cash flows that arise in fulfilling insurance obligations over the full time horizon thereof;
- The valuation of technical provisions allows for the time value of money. The solvency regime establishes criteria for the determination of appropriate interest rates to be used in the discounting of technical provisions; and
- The solvency regime requires the valuation of technical provisions to make appropriate allowance for embedded options and guarantees.

Underlying the IAIS solvency standards is a desire to achieve greater levels of transparency to their supervisors and the public, so that insurers are more disciplined in their actions.

These requirements will herald a significant change in many jurisdictions regarding how insurance contracts are measured and reported and the impact of this change should not be underestimated.

Further amendments to the IAIS valuation standard are expected as a result of the formal consultation process, which is expected to commence in Q1 2011. The IAIS is scheduled to formally adopt the valuation standard and for it to become effective as applying to all jurisdictions world-wide from Q4 2011.

Disclosure

Closely aligned with the valuation developments are the supervisory review and reporting requirements, now beginning to be discussed at an international level. The aim is to harmonise and converge reporting and disclosure requirements particularly given the IFRS changes.

Underlying the IAIS solvency standards is a desire to achieve greater levels of transparency to their supervisors and the public, so that insurers are more disciplined in their actions. While the IAIS does not yet specify reporting requirements such as a public Solvency and Financial Condition Report (SFCR) under Solvency II, it is very likely that most supervisors will establish a similar framework, which requires a private regular (typically annual) supervisory report (which may also take the form of simplified quarterly reports) and a public SFCR that increases the level of disclosure required of insurers. At present, the US financial reporting requirements, data collection and system analysis is considered by many as the most comprehensive.

What are the implications?

- The IASB and IAIS changes to valuation measurement, recognition and reporting of insurance contracts – especially the move to a market-consistent and economic balance sheet complemented by risk-based capital requirements from regulators – will prove extremely challenging for many insurers.
- Such changes are likely to require insurers to re-engineer their existing processes to facilitate and possess timely and robust measurement and reporting capabilities – applying increased pressure on both resources and costs. Early budgetary preparations and contingency plans should now be undertaken.
- Pro-active action taken now should lead to insurers being able to gain competitive benefits by aligning data and systems with liaison and coordination activities.
- The new valuation rules are likely to require transitional arrangements particularly concerning changes to financial information. This will require clear and concise communications with external stakeholders such as analysts, shareholders and supervisors.

Issues to consider

- Have you fully considered the extent of changes to valuation measurement, recognition and reporting of insurance contracts and what impact these changes may have on your business?
- Will the move to a market-consistent and economic balance sheet complement your internal risk-based capital capabilities?
- Have you undertaken impact assessments to identify changes to data and technology to meet new calculations?
- Have you commenced high level modelling to understand impact on returns of proposed changes?
- Do you know the impact on back office and risk management processes of changes in insurance contracts?
- How prepared is your organisation for meeting the new disclosure and reporting requirements, particularly with regard to risk and capital management information?
- Will your firm be able to meet the increasing technical demands expected? Do you have the right capabilities and skill sets of staff especially in regards to actuarial, risk and finance operations to fully implement the new demands and changes expected?
- How will you prepare yourself to understand and explain differences arising under different reporting systems?



04

Investments and liquidity

Improving cash flow and flexibility

Insurers remained relatively stable during the financial crisis because their business model is fundamentally different from that of banks. Unlike banks, they are funded by upfront premiums, so they do not generally rely on wholesale market funding for liquidity. Insurance policies are also generally long-term, with controlled outflows, and investments are generally matched to liabilities.

Another factor which assisted insurers cope well with the crisis is that under many RBC solvency capital regimes, insurers are required to hold capital for asset risks. This meant that many insurers were holding significant capital reserves to meet those risks (such as exposure to falling equity markets or lower quality investments). In Australia, for example, such capital is required against valuation risk, concentration risk, mis-matching risk and credit risk.

Investments

However, the GFC highlighted across the world that there are no uniform investment requirements or asset class restrictions from supervisors. Each jurisdiction essentially has bespoke requirements on the investments permitted to be held by insurers. The absence of such a standard raised particular issues regarding how the IAIS responded to concerns being addressed by the FSB, such as liquidity given the impact of this risk on the banking sector.

In response, the IAIS standard on investments addressed many of the issues which arose immediately following the crisis. Recognising the diverse positions held by regulatory authorities to investments, the IAIS standard allows either a principles-based or a rules-based approach, or a mixture of the two, in setting regulatory investment requirements. The standard allows the Solvency II approach of the prudent person principle particularly in relation to the requirements regarding the asset portfolio, where, at a minimum, regulatory investment requirements will be expected to address the security, liquidity and diversification of an insurer's portfolio of investments as a whole.

Insurers will be expected to invest in a manner that is appropriate to the nature of their liabilities and invest only in assets whose risks they can properly assess and manage. In relation to specific financial instruments, solvency regimes will be expected to establish quantitative and qualitative requirements, where appropriate, on the use of more complex and less transparent classes of assets and investment in markets or instruments that are subject to less governance or regulation. Solvency II has outlined such measures already for innovative arrangements such as special purpose vehicles.

A specific issue for regulators, which arose during the GFC, was whether off-balance sheet vehicles truly were off balance sheet, or whether in stress scenarios losses should be recognised due to implicit obligations of support, unhedged derivatives or from structured credit products. Increased scrutiny of such investments can now be expected by regulators world-wide.

Similarly, the issue of whether an insurer's assets are sufficiently secure has received increased attention, particularly concerning whether undue reliance is placed on credit rating agencies. The GFC has prompted many supervisors to require insurers to become more aware of the limitations in relying on credit ratings and to require insurers to undertake more due diligence in assessing their counterparty credit risk exposure. Such focus will continue to apply pressure on the robustness of the systems and controls used in the insurer's risk management and Asset Liability Management (ALM) practices.

Insurance groups

For insurance groups, the significant focus of regulators is now turning to the degree of transferability and fungibility of capital, the inherent investment risk at the insurance legal entity level and the overall risk exposures at an aggregated level across the group. Of particular concern is whether investments undertaken by certain legal entities can weaken the group and whether intra-group investments pose additional risks given any explicit or implicit support arrangements.

The GFC highlighted situations where supervisors were concerned both at their lack of power to prevent capital flight across national borders in stress conditions, and insurers' inability to mobilise capital at short notice in stress circumstances. This is particularly

Such focus will continue to apply pressure on the robustness of the systems and controls used in the insurer's risk management and Asset Liability Management (ALM) practices.

significant given that many regimes focus on regulating legal entities rather than on groups and supervisors in many countries do not yet have the full legal power or capability to undertake group supervision. This has led to supervisors questioning whether diversification benefits are real, if they cannot be achieved with certainty in stress conditions.

All of these concerns mean that investments, particularly those held at a group level, must be monitored to ensure that they are sound, appropriate and able to be accessed when needed to support capital or liquidity requirements in stress conditions. In our view, insurance groups that fail to adequately address these issues by being able to verify benefits such as diversification will find their supervisors increasingly likely to question the group's overall financial resources and capital requirements.

Liquidity

The GFC resulted in a number of initiatives by banking regulators concerning liquidity requirements and these actions continue. In insurance, despite pressure from the FSB to the IAIS to examine potential reform of liquidity requirements, there has to date been no changes. Even though some industry participants acknowledge that certain activities, such as commercial paper borrowing and stock lending activities, may theoretically pose liquidity issues, the general consensus has been that an insurer's asset-liability management is likely to protect against significant liquidity problems.

This position reflects the inherent difference between the banking and insurance models. Primarily the difference is between deposits and wholesale funding in banking compared to the insurance model where premiums, are received and invested ahead of the crystallisation of claims and benefits payments. This results in a fundamental difference between the balance sheets of the two sectors. While insurers need liquidity to pay claims, the pattern of claims payments, especially for most life firms is usually reasonably stable and predictable. Product designs typically contain safety mechanisms, such as surrender charges, to protect against spikes in liquidity. Generally, while the claims payments for general insurers may be less predictable, peak risks associated with natural catastrophes are not generally correlated with periods of economic distress. However in stress conditions insurers may 'gamble for survival' by writing unprofitable new business in order to generate cash to satisfy claims payments expected in the near term.

However, liquidity risk is generally considered to be lower in insurance, with most supervisors focusing on asset-liability matching principles and general risk management requirements as a means to addressing any potential liquidity issues. Recently, this has been reinforced by increased demands from supervisors to stress test investment portfolios and even to apply reverse stress tests to better assess liquidity positions of insurers, particularly in regards to the risk of a sudden

In many countries, insurers are typically required to hold assets substantially in excess of their liabilities at a local subsidiary level, and these are sometimes ring fenced from the insurer's other operations.

withdrawal of policyholders with guaranteed surrender values.

In addition, in many countries, insurers are typically required to hold assets substantially in excess of their liabilities at a local subsidiary level, and these are sometimes ring fenced from the insurer's other operations. For example, all carriers in Singapore must hold their local and foreign insurance business in separate funds, with surplus assets held in each fund which are in excess of their domestic and foreign liabilities.

ASPAC

Cash flow and liquidity risks are a particular area of focus for regulators across much of the ASPAC region, in particular in jurisdictions where local debt markets are less deep and liquid. Duration matching may not be achievable because there are insufficient assets of a duration to match insurers' longer term liabilities, giving rise to reinvestment risk.

What are the implications?

- The liquidity issues are clearly different for insurers compared to banks, however regulators have still increased their attention and enquiries regarding insurers' cash flows.
- The use of risk measurement techniques such as stress and reverse stress tests and scenario analysis tools requires insurers to invest properly in ensuring that their short and long term liquidity positions are clearly understood and managed.
- Changes to permitted asset admissibility criteria in jurisdictions embracing a prudent person approach are likely to provide insurers with greater flexibility in managing

their investment portfolios and allow greater use of innovative investments. Relaxation of permitted asset rules will be offset by increasing oversight of insurers' asset-liability processes, management oversight, governance and related systems and controls.

- Increased reliance on supervisory oversight of the insurer's own investment strategies will require greater focus on clear articulation of risk appetite, the insurer's risk profile, risk tolerance and overall financial objectives. Insurers will need to ensure that their controls over investments held to cover technical provisions and capital requirements are fit for purpose.

Issues to consider

- How robust is your liquidity planning, governance and modelling?
- How adequate and robust is your cash-flow analysis?
- Do you understand the risk profiles of different investments currently held? Are you sufficiently aware of the extent of investment guarantees and embedded options contained in policies and the potential impacts these may have on your financial resources?
- Are systems, data and management reporting adequate to meet your needs in stress conditions?
- Have you considered your approach to stress testing and the data required?
- What are your communication plans for new requirements?
- Do you appreciate the implications for pricing, funding and regulatory ratios in your firm?
- Do you have sufficient awareness of investment guarantees and embedded options contained in policies?
- Are you sufficiently aware of the impact of changes on your investment strategy given increased regulatory attention to off-balance sheet and 'non-regulated' activities?
- Do you have a clear picture of portfolio management strategies required to properly take account of changes in risk profile and capital?
- Are your systems and data capable of satisfying the new reporting and supervisory information requirements?

Perspectives: Europe

Implementing the new regime

Due to be implemented in 2013, Solvency II will herald a new era of prudential regulation across Europe. Although the development of Solvency II was well underway before the global financial crisis (GFC) of 2008/09, its risk-based approach and focus on governance, group supervision and regulatory cooperation has been widely accepted as the best way to mitigate future crises.

Solvency II will, for the first time, require insurers to identify, measure and proactively manage risk, as well as consider future developments, such as new business plans or catastrophic events that might affect their financial standing. The new rules also require far greater levels of public and regulatory disclosure.

Under the new regime, insurers will be able to use approved internal models to calculate their capital requirements, in consultation with supervisors. Alternatively, insurers can use a standard formula and in both cases will be required to hold capital against all risks to the balance sheet, including operational, credit and market risks, which are currently not considered by Solvency I.

In recognition that one-size may not fit all, Solvency II also recognises the need for flexibility under the framework, depending on the nature, scale and complexity of the company. The principle of proportionality is intended to reflect the range of insurance entities operating in Europe, from small specialist carriers and mutual insurers up to complex international financial services groups.

The regime will allow for the principle of proportionality to apply to the calculation of capital requirements, to the review of the risk management and governance processes as well as to the disclosure requirements. I believe this is good news for all insurers as it demonstrates that what European insurance supervisors

are focussed upon are the outcomes that such regulation provides – which is ultimately better policyholder protection.

Solvency II will also focus on group supervision and group solvency of international insurers operating in the EU, and include provisions that will allow greater cooperation with overseas regulators.

The new regime will also pay more attention to:

- Group supervision and to assessing group risk;
- Strengthening the powers of group supervisors;
- Fostering greater cooperation between regulators; and
- Furthering supervisory convergence.

The crisis did, however, influence the development of Solvency II and the ongoing calibration of the regime. An earlier version of the framework proposed a group support regime, enabling insurers to pool capital resources across the group, rather than hold funds at a member state level. Against the backdrop of the GFC, some EU states opposed the concept and group support was consequently dropped from the final framework directive, with a review planned for the end of 2015. In my view such proposals can only succeed if there is true international agreement around prudential requirements. This is why the IAIS ComFrame work is so important.

So what are the main features of Solvency II?

In essence, Solvency II is constructed using a three pillar approach as outlined in [Diagram 4](#).

Pillar 1 outlines the financial requirements. This pillar aims to ensure firms are adequately capitalised with risk-based capital. All valuations of assets and liabilities in this pillar are to be done

Such proposals can only succeed if there is true international agreement around prudential requirements. This is why the IAIS ComFrame work is so important.



in a market consistent manner. This pillar also includes the potential use of internal models, which, subject to stringent standards and prior supervisory approval, enables a firm to calculate regulatory capital requirements using its own internal model which is more tailored to its risks than the standard formula.

Pillar 2 is concerned with imposing standards of risk management and governance within a firm’s organisation. This pillar requires supervisors to challenge their firms on risk management issues. The ORSA requires a firm to undertake its own forward looking self assessment of its risks, corresponding capital requirements and adequacy of capital resources.

Pillar 3 aims to achieve greater levels of transparency to their supervisors and the public so that firms are more disciplined in their actions. There is a private annual regular supervisory report and a public solvency and financial condition report that increase the level of disclosure required by firms.

Equivalence

Solvency II also recognises the international dimension of insurance and the ties that exist between insurers operating in Europe and certain other markets.

In order to assess the risks to European policyholders, EU supervisors will need to consider factors at a group level, potentially including group entities and subsidiaries outside the EEA. This has led the EU in its development of Solvency II, to consider recognising the supervisory work of overseas insurance entities through the concept of ‘equivalence.’

The provision of equivalence in Solvency II recognises the potential to reduce the duplication of supervision between regulators and compliance for insurers with operations outside the EU.

The provisions allow the EU and member state regulators to assess the supervisory regimes of countries outside the EEA-known as ‘third countries,’ in particular where an EU insurer transacts business with non-EU reinsurers; where it operates on a global level; or where it may be part of a non-European group.

Equivalent reinsurance to receive equal treatment

The Directive allows for the conclusion of mutual recognition agreements with third countries concerning the supervision of reinsurance entities that conduct business in member states. Reinsurers that are covered by an equivalent regime will be treated the same as EU reinsurers, but those that are based in non-equivalent regimes may be required to pledge assets to cover unearned premiums and claims provisions, or localised assets for risks situated in the EU.

Unrated equivalent reinsurers will be treated as having a 10 percent probability of default, or a B/CCC credit rating, while equivalent non-rated reinsurers will be considered BBB under the standard formula for assessing capital requirements.

Diagram 4: Three Pillar Approach

Three Pillar Approach		
Pillar 1	Pillar 2	Pillar 3
Quantitative capital requirements <ul style="list-style-type: none"> Balance sheet (including technical provisions) Minimum capital requirement (MCR) Solvency capital requirement (SCR) Investment principles 	Qualitative requirements and supervisory review <ul style="list-style-type: none"> Governance, risk management and required functions Own risk and solvency assessment Supervisory review process 	Reporting, disclosure and market discipline <ul style="list-style-type: none"> SFCR and RSR Disclosure Transparency Support of risk-based supervision through market mechanisms
Market-consistent valuation risk-based requirements	Business governance risk-based supervision	Disclosure transparent markets

Source: KPMG International, February 2011.

Regulator can use discretion when considering group supervision

Solvency II also allows for supervisory equivalence when calculating group solvency and group supervision of non-EU headquartered groups. The EU regulator may require a group-wide solvency assessment, risk management and an ORSA, even if the entity is based outside the EU.

However, the EU regulator may take account of a third country capital requirement in its solvency assessment, and can use its discretion when assessing group solvency, it can also use alternative approaches to determine the most effective means of supervision.

In its consultation paper on assessing third countries for equivalence, CEIOPS says that third country regimes would be expected to provide a similar level of policyholder protection as that provided by Solvency II. However, when assessing each principle and objective not every 'indicator' would need to be met, and proper consideration would be given to the concept of proportionality.

Which countries are likely to seek equivalence with Europe?

The inclusion of provisions for equivalence reflect the EU's recognition of the international nature of the European insurance market and its close ties with other markets. Equivalence would make EU supervision more effective, reducing the compliance burden for insurers and making for more effective regulation of international groups.

The EU will assess the equivalence of third-country regimes in waves of assessments. In prioritising assessment the EU will consider which countries are most relevant in terms of providing reinsurance to EEA insurers, where EU insurers have substantial amounts of business, and where groups operating in the EU have foreign ownership.

Switzerland, Bermuda and Japan (for reinsurance) are to be assessed in the first wave, under the advice from European Insurance and Occupational Pensions Authority (EIOPA). A noticeable omission from this list is the US, where the state by state approach to insurance regulation poses challenges in assessing equivalence. The implication of the US not gaining equivalence could have a significant impact on US insurers caught by Solvency II.



Rob Curtis
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What can others learn from the Solvency II experience?

While Solvency II has just under two more years before becoming effective, there are already clear lessons to be learned from the experiences of many insurers which have a read-across to the nature of change that will be required for non-European insurers in implementing ORSA and internal model programmes. Some of these key lessons are:

- Don't under-estimate the time and resources required to implement the changes needed. Solvency II is an enormous change programme affecting every part of the business from risk and capital management, to governance and internal controls, Board oversight and responsibilities to reporting and disclosure. Effectively every facet of an insurer's business requires some form of enhancement.
- Good planning and project management is essential. Key resources and staff with specific skill sets suddenly become a scarce commodity. Early preparation and awareness by the Board and senior management are needed to fully appreciate the scale and complexities involved.
- Data and system issues presented significant challenges for most European insurers. While Solvency II expects reliable and robust information to calculate Pillar 1 and technical provision requirements, in addition to meeting ORSA and reporting purposes, there has also been a fair degree of uncertainty regarding the veracity of information. One of the issues encountered has been the extent and use of management actions – particularly where there are data issues.
- Boards and senior management have needed clear strategic plans and purpose regarding programme sponsorship and to set clear accountabilities and establish agreed deliverables. Most Solvency II programmes have needed a strong project team to provide a clear and well articulated programme plan creating the necessary road-map for stakeholder input and continued involvement.
- A major challenge for all European insurers has been in setting risk appetite and risk limits. Ensuring the integration of these elements into the insurer's economic capital, ORSA and internal model framework has proven to be both complex and involved. Careful planning and analysis has been essential.
- Regular feedback and open communication channels have been key to most successful European Solvency II programmes across the business. Solvency II projects have required the collective input from a wide cast of stakeholders, and this has become even more important for groups with subsidiaries and branches in non-EEA countries. Achieving the right balance between local and group requirements and input has been difficult.
- For many European insurers, the Solvency II work has required input from many business units and stakeholders from across the business. Insurers that have not appropriately appreciated or managed the different cultural perspectives and inputs and communicated the benefits of involvement, have found it more difficult to manage the competing priorities that invariably arise between business-as-usual activity and meeting project deliverables.
- Ensuring timely and effective management information is absolutely essential to most Solvency II projects. Too often reporting lines have been opaque for meeting delivery schedules and information flows have suffered.
- Documentation requirements are extremely important for Solvency II, especially as the review of any work performed will need to be supplied invariably to external audiences namely supervisors, credit rating agencies and analysts. The quality and cohesiveness of this material must be of a high order and this ultimately places resource constraints on insurers.

Insurers that have not appropriately appreciated or managed the different cultural perspectives and inputs and communicated the benefits of involvement, have found it more difficult to manage the competing priorities that invariably arise.

Governance and internal controls

Changing gears

A number of new initiatives concerning governance and internal controls which will impact insurers are being pursued by supervisors. All of these changes are designed to instil the right behaviours in insurers and establish new skill sets across key functional business areas of risk, finance and strategy. Increasingly supervisors are beginning to examine issues concerning behaviours/ethics and culture. Regulators are considering playing a greater role in assessing behaviour and even ethics; in effect, an insurer's culture is not beyond the remit of regulation.

Insurers will need to be aware of their culture and 'tone at the top', as this influences behaviour throughout the organisation. The recent furore over bankers' bonuses is an example where regulators are under immense pressure to respond to a financial sector perceived as lacking an appropriate ethical framework within which actions and decisions were grounded, or if such a framework was promulgated it was not adhered to.

In response, a number of jurisdictions, such as the EU, either have or are in the process of regulating remuneration. A key focus for insurance supervisors will be whether remuneration schemes may increase risk taking within firms or unduly influence management decision making. Companies will need to review their performance and reward strategies to ensure alignment with their organisation's overall risk strategy and culture.

Many supervisors also have strict 'fit and proper' criteria on the suitability of key persons whether owners or management, namely Board members, senior management and key persons in control functions. A key criterion for holders of these roles is possession of sufficient competence and integrity in the fulfilment of their duties. Fit and proper requirements are likely to extend to most outsourcing arrangements.

Increasingly supervisors want to see operational independence of the main governance functions of risk management, compliance and actuarial with approved persons being responsible for the management of such functions. The likely trend is that this may even extend to the supervisor requiring that they pre-approve the appointment of such function holders.

Similarly, supervisors are now beginning to expand their expectations of the risk governance framework employed by insurers, progressively moving to a 'three lines of defence' model. Under this approach, functions and business units form the first line of defence, with the oversight functions of risk and control forming a second line of defence, with internal audit providing the third line of defence, through independent assurance over the first two lines of the model. As such, the expectation is that internal audit is fully independent. Sitting above these functions are various governance committees – such as the Board risk committee, remuneration committee and other executive committees with the Board presiding over each. Sitting independently to the other committees would be the Audit committee. Clear lines of responsibility, delegated authorities and accountability for reporting are fundamental to sound risk management and insurers will need to ensure good governance in order to fulfil their ORSA commitments.

Supervisors are also beginning to assess the risk operating model of the insurers they supervise. At the centre of these considerations are the risk function's mandate and the extent to which controls and behaviours are embedded. Supervisors are now assessing the quality of risk advice provided, the risk coordination activities that are undertaken and how they are performed in practice, the extent and quality of risk monitoring undertaken and the challenge given to the business units. This scrutiny may require insurers to strengthen second line functions. Failure to establish a 'three lines of defence' model may be seen as a

What are the implications?

- Through on-site visits, supervisors are increasingly examining the alignment of strategy, the insurer's own risk operating model and risk function capabilities and making judgements about the governance and internal control environment of the organisations they supervise. It is therefore critical that insurers are sufficiently aware of these increased expectations and are properly prepared to address any weaknesses.
- Above all else, supervisors are moving towards an operating model that requires strong accountability by key function holders. Key individuals

will be assessed as much as the function. Insurers therefore need to ensure high quality candidates capable of managing these functions are selected.

- New areas of regulatory interest are ethics and culture. Organisations that ignore these important considerations may encounter more intrusive supervision.
- Remuneration considerations are currently very topical and may become a heightened area of supervisory inquiry. Roles between key function holders should be clear and areas of duplication eliminated.

Issues to consider

- Do you operate a 'three lines of defence' model?
- Do you regularly review your governance structure for effectiveness?
- Are roles and responsibilities clear between key function holders?
- Can you fulfil requirements to up-skill the Board and senior management and demonstrate capability?
- Does your organisation have an appropriate ethical framework and culture for a regulated entity?
- Are you ready to demonstrate and attest to effective internal controls, e.g. over risk and capital integration?
- Is your management information sufficient to meet the requirements of the Board and effective risk management?

material weakness in the company's overall governance and risk management framework and could impact upon the insurer's capital requirements.

While risk management is the responsibility of the Board as a whole, some supervisors are beginning to designate at least one member of the Board to oversee the risk management strategy (RMS). Reinforcing the responsibility of the Board, most supervisors will soon be assessing the Board's effectiveness in setting strategy, risk appetite, tolerance limits and policy. Supervisors will also expect that the Board is kept fully informed of reputational risk exposures and the correlation this may have to other key risks.

To complement these changes in regulatory focus, the role of Chief Risk Officer (CRO) is increasingly viewed by supervisors as a necessary function holder role within insurance companies. The challenge for most firms will be to clearly articulate the responsibilities of the CRO, the Chief Financial Officer, the Head of Actuarial and even that of a Chief Compliance Officer. Demonstrating that these structures are working effectively will be a major focus for many supervisors going forward and appropriately documenting such arrangements will be an ongoing challenge for many insurers.

06

Customer treatment

Changing conduct of business

It is not only in prudential regulation that significant changes are occurring. In many markets, substantial changes are being made to the conduct of business requirements and the fair treatment of customers.

An example of this is in the UK, where in June 2010 significant changes were announced concerning the regulatory tripartite regime involving the Financial Services Authority (FSA), the Bank of England and the Treasury, by effectively breaking up the FSA.

It is planned that the FSA's responsibilities will be handled by three new agencies:

- Reporting to the Bank of England the Prudential Regulatory Authority will be responsible for prudential regulation of all financial firms;
- The Financial Conduct Authority (FCA) will regulate the conduct of every authorised financial firm providing services to consumers; and
- The Financial Policy Committee, led by the Bank of England, will be responsible for addressing macro-prudential issues.

The establishment of the FCA as a body dedicated to consumer issues reflects the thinking behind the FSA's Retail Distribution Review (RDR), due for implementation in January 2013, along with the current European Commission's Packaged Retail Investment Products (PRIIPS) consultations. In undertaking the RDR and planning its subsequent wide-ranging associated regulations the FSA set out their objective as:

- Improving the clarity with which regulated firms describe their services to consumers;
- Addressing the potential for financial adviser remuneration to distort consumer outcomes; and
- Increasing the professional standards of advisers.

This was driven by a belief that adviser remuneration and a lack of transparency had acted against consumers' best financial interests.

Meanwhile, the European Commission states its objective is to create a framework that will provide effective standards for the protection of investors as "they do not understand products because they are complex and the accompanying literature is hard to understand". Thus the PRIP looks to ensure complete clarity on disclosure, such that the information is clear, concise, timely and appropriate, while the principles on which the selling requirements will be designed include:

- Selling practices must be focused on the fair treatment of the investor;
- Investment advisers should ensure products sold correspond to the profile and needs of the investor, and that the investor understands the nature of the service being provided by the adviser;
- If a product is sold without advice, the limits to the service provided and risks for the investor must be clear. An assessment of the adequacy of the product may still be required in some circumstances;
- For both advised and non-advised sales, conflicts of interest must be avoided where possible, or be identified, managed and disclosed in a way that investors can understand;
- For both advised and non-advised sales, investors must receive clear and effective disclosures of remuneration arrangements and all charges, commissions or fees paid, in a form they can use; and
- Those assessing the suitability of products must fully understand those products and their features.

What do these changes mean for insurers?

The increasingly consumer centric regulatory drive has potentially significant implications for insurers. The RDR regulations in the UK will outlaw commission and demand that advice is paid for from customer fees. It will ensure that the consumer is clear on the type of advice they are receiving and that advisers are significantly more highly trained. The impacts of such changes are likely to be significant as the changes re-define some of the commercial fundamentals that underpin the whole pensions and investment market. As such, the new regulations have the potential to create a ripple effect of change, which will run right across organisational structures and individual corporate commercial models. Simple compliance with RDR will not be the end for organisations, because the regulations will demand a more strategic and pan-organisational response.

The new regulations have the potential to create a ripple effect of change, which will run right across organisational structures and individual corporate commercial models.

So what are these fundamental market shifting changes? They can be characterised in three areas; consumer, markets and operational.

Consumer

Currently consumers can be segmented and targeted by providers and intermediaries in a proactive manner, since the perception of the vast majority of consumers is that the advice (or sales) process is 'free'. Thus the customer engagement process is simple and based upon capturing the consumer's attention and advising/'selling' to them. With the new consumer centric regulation the balance shifts as the consumer now needs to be persuaded to pay for something that they previously perceived to be free i.e. the engagement process (and which in many cases they attached no value to). So advice becomes the product but will the consumer want to buy it?

Markets

The impact on the market is currently characterised by imponderables:

- How many Independent Financial Advisors (IFA) will survive by 2015?
- Will product providers and fund managers create direct distribution offerings to protect their route to market?
- How will platforms re-shape the fee distribution model?
- Will new entrants cherry pick consumer segments?
- Will IFAs gravitate to High Net Worth clients?
- What will be the impact of consumer use of comparison and on-line peer advice sites?

In this market of moving parts, organisations need to identify where they can succeed and re-shape their models accordingly.

Operational

This re-shaping naturally leads into the extensive operational impact. Alongside the potential requirement for revised strategies, operating models and innovative customer engagement approaches, are the core requirements for product re-design, re-thinking on capital requirements, increased demands on IT and the need for improved data quality.

In many markets, the seeming shift in regulatory focus, from a balanced approach of protecting the consumer within commercially reasonable boundaries to a purely consumer protection role, will have major implications for the whole market.

North America

US regulators have always been heavily focused on consumer protection, but the GFC has added additional pace and pressure to modernise and reshape market conduct requirements.

Within the US each state is responsible for legislating and enforcing insurance regulation – historically driven by consumer considerations and the safety and soundness of the insurance industry. However, the financial crisis has reignited the debate over federal regulation and added an international dimension to potential changes in domestic regulation. It should be noted that US insurers generally performed much better than their banking counterparts during the crisis with 297 US banks failing in 2009 and 2010, compared to only 30 US insurers over the same time period.

The US market regulatory framework is broad with resources being devoted to market regulatory issues. Areas within the broad category of market regulation consist of oversight of insurers' product development and pricing, monitoring insurer market practices, monitoring competition, statistical reporting, residual market administration, licensing

of insurance producers and consumer information and consumer assistance services.

Over the last decade progress has been made by US regulators toward modernising many of the market regulatory processes. For example, in the area of product filing and review, regulators and legislators have enacted an interstate compact for certain life, annuity, disability income and long-term care products. The compact is a system that seeks to enhance the efficiency and effectiveness of the way insurance products are filed, reviewed and approved allowing consumers to have faster access to competitive insurance products in an ever-changing global marketplace. The compact promotes uniformity through application of national product standards embedded with strong consumer protections. Insurers now have access to a single point of filing and uniform national standards for eligible products. Currently 38 states representing over 60 percent of the eligible premium volume are members of the compact.

Traditional market conduct examinations have also been evolving in the US. The US regulators are moving toward increased use of market analysis tools to replace the traditional on-site market conduct examination. As part of that evolution, regulators have developed the Market Conduct Annual Statement (MCAS) to collect pertinent statistical information from insurers to evaluate and monitor certain areas of market performance. The MCAS submissions have been centralized at the NAIC with 45 US jurisdictions participating in the effort.

A number of US life insurers were hit particularly hard by the financial crisis. Variable-annuity policies are a popular savings product in the US, and a number of writers of this business offered guaranteed minimum death and living benefits. US regulators have been

monitoring the variable annuity writers, particularly those with the guaranteed minimums. It is possible the US regulators will encourage more conservatism in the offering of guarantees.

As a result of the challenges in the US life industry, there has been a 'flight to quality' resulting in a shift in consumer demands. Annuity sales in the US are depressed and more traditional life products, particularly whole life, are experiencing a resurgence. However, it is uncertain how this recent trend will pan out in the long-term as the needs of the 'baby boomer' generation play an increasingly dominant role in the industry.

From a regulatory perspective, there has also been enhanced scrutiny around the suitability of products in the US, which historically has always been high on the regulatory radar. The regulatory focus has increased and expanded to look deeper into products such as fixed annuities.

The Dodd-Frank Act established the Consumer Financial Protection Bureau (CFPB) in July 2010 and as yet it remains unclear what insurance products, if any, will be caught under this Federal watch dog. Additionally, further insurance reform is slated on Capitol Hill for 2011.

ASPAC

Models of consumer protection vary significantly in ASPAC but generally have not yet embraced the principles based customer-centricity seen in the EU and UK developments discussed above. Instead, many countries still focus on achieving consumer protection through regulatory pre-approval of product designs and pricing. Current areas of regulatory focus include increasingly stringent controls over data privacy, impacting direct marketing and cross-selling, controls over who may sell insurance in bank branches and increased control of selling practices in respect of investment linked products.

What are the implications?

- Significant conduct of business regulatory changes are occurring which will have important implications for product development and distribution processes.
- Increased regulatory focus on pushing simplicity and transparency for consumer products will have implications for innovation and choice in consumer products.
- The EU and UK are issuing major changes to distribution of retail products (PRIPs and RDR respectively) and will be a major focus for many insurers.
- Fundamental changes to strategy and existing business operating models are likely to be needed for some markets.
- The capital impact could be significant and will require careful analysis.
- There is also likely to be a need for better IT, data and system requirements by insurers.
- Increased reporting and disclosure requirements will most likely be introduced.

Issues to consider

- How will product strategy evolve to meet and take advantage of new rules?
- How will the sales process and collateral need to change?
- What are the opportunities for services to customers?
- Will systems, data and reporting be in place to meet new requirements?
- How aware are you of the potential risk and capital impacts such changes may have on your business?
- Increased regulatory focus will require many insurers to devote more resources to conduct of business issues – are you prepared?

The financial crisis has reignited the debate over federal regulation and added an international dimension to potential changes in domestic regulation.



07

Group-wide and cross-border supervision

Driving global consistency

Considerable efforts continue at an international level to harmonise prudential insurance regulations, promoting common standards and approaches, as well as encouraging cooperation between supervisors. Solvency II will harmonise regulation in Europe, and potentially open the way to greater cooperation and mutual recognition with other markets.

Globalisation and the growth of multi-national insurance groups, coupled with more sophisticated products and financial markets, has led to calls for better supervision of cross-border and global insurance and reinsurance groups.

Group supervision

The GFC has highlighted the need for effective group supervision and reinforced calls for common principles and standards, and greater cooperation between regulators, in particular for cross-border groups and to manage systemic risks. Last year, the G20 agreed actions to promote financial regulatory reform, including greater consistency and cooperation between countries, and a framework of internationally agreed high standards.

One of the key findings from the GFC, and the role of systemically important financial institutions (SIFIs), has highlighted that monitoring an insurer only at the legal entity level is not sufficient. Supervisors involved in group-wide supervision need to be able to assess all relevant information on all risks to which the insurance group is exposed. However, complex and highly

centralised groups make it almost impossible to rely solely on solo level data to adequately address the risks at the solo level. Indeed, the global size and complexity of many IAIGs evidences the need for formal supervisory cooperation, including the timely exchange of relevant information and the need for supervisors to close any regulatory and supervisory gaps in group-wide supervision. A key issue identified during the GFC is the extent of supervision applied to non-regulated subsidiaries and off-balance sheet items.

Comparability and convergence

The GFC also highlighted strong arguments in favour of greater convergence of supervisory practice. Despite current changes in many jurisdictions, the global insurance sector is still subject to different accounting, capital adequacy and legal regimes around the world. This has resulted in a low level of regulatory harmonisation and convergence of supervisory practice when compared to the banking sector. One pertinent issue to arise from G20 and the FSB driven discussions, has been the frequent requests to supervisors for hard data on insurance activities. However, at present, there are no globally consistent solvency reporting or measurement tools for assessing insurer solvency amongst supervisors. This is in marked contrast to the banking sector where the Basel Committee for Banking Supervision (BCBS) established common capital requirements for all internationally active banks in 1988. These were substantially improved under Basel II in 2004 and will now undergo further reform as a result of Basel III. Similarly, the International Organization of Securities Commissions (IOSCO) apply a common capital requirement for the trading book, on the same basis as the BCBS. Such common benchmark

requirements have been demonstrated not only to contribute to enhanced market confidence and stability but also to facilitate effective banking supervision by providing common understanding and consistent data among the supervisors.

So what is changing and what impact might this have for insurers?

Given the scale and complexity of large insurance groups, the extent of cross-border activities and the importance of such institutions to local and international financial systems, inconsistent implementation of regulatory and supervisory requirements among IAIS members means that the effectiveness of international supervision is limited. In turn this limits the effective protection of policyholders, the promotion of financial stability and, moreover, may permit regulatory arbitrage. Inconsistent standards around the world, could allow the relocation of headquarters and the transfer of significant risks within a group to a less sophisticated and under-regulated jurisdictions, which could result in a greater concentration of risks in certain jurisdictions. Naturally this is of particular concern to supervisors. The lack of common supervisory standards could even trigger a 'race to the bottom' by insurers seeking less sophisticated regulation.

Furthermore, it can be complex, resource intensive, and at times impractical, for supervisors to fully understand and assess the supervisory frameworks and practices of other jurisdictions, because there is so much variation in practice. Thus, it can be difficult for supervisors to share information and consolidate such information to reach a common understanding of the financial and risk positions of large insurance groups. This can impact the efficient and effective supervision of complex insurance groups.

However, at present, there are no globally consistent solvency reporting or measurement tools for assessing insurer solvency amongst supervisors.

The role of supervisory colleges only serves to underline this point. Without a common solvency language among supervisors and insurers, the effectiveness of such colleges is hampered. For example, the assessment of the financial condition and risk management of a large multi-national insurance group will be complex if each jurisdiction imposes different requirements for risk measurement and capital determination. If a specific risk is valued using a risk sensitive capital requirement in one jurisdiction (such as using an internal model), a rule-based capital requirement in another (such as a standardised or RBC approach), and other supplementing measures (such as investment limits) or qualitative requirements (such as controls over governance) in another jurisdiction, the scope for consolidating each jurisdiction's assessment of the risks and financial positions will be limited. Hence it may be difficult for supervisors to establish a comprehensive view of the risks to which a specific insurance group is subject. Added to this scenario is the fact that a college for a large international group is almost certain to involve supervisors from different jurisdictions meaning a common language becomes even more important. All of these inconsistencies greatly add to the costs of insurers in meeting multiple requirements.

Greater commonality

Therefore it is very encouraging that the IAIS has commenced its ComFrame project (see Chapter 9), for which one of the principal aims is to explore the extent to which a common supervisory framework can be achieved, with solvency assessment being at the core of such requirements. Similar to the Basel Accord for banking, this project will aim to go further than the existing

IAIS supervisory principles, standards and guidance. Specific criteria measures (in the form of parameters and specifications) will be developed. Coupled with the generation of new reporting and supervisory review requirements, the ComFrame will certainly be a key solvency development for many years to come.

The following summary sets out some of the key areas of development now being actively pursued by supervisors in the establishment of enhanced global mechanisms to achieve a common framework. Early awareness by insurers of such developments will provide a competitive advantage to improve their risk management practices, governance and capital allocation methods and generally improve their business models world-wide.

Quantitative aspects of solvency assessment and supervision

- A common approach on valuation is a necessary precondition of effective common RBC requirements (valuation is an integral part of solvency assessment) and it is expected that IFRS developments will assist in providing such a common platform;
- Establishing a global solvency framework is very likely to mean the introduction of consistent risk-based requirements such as risk-sensitive capital requirements and/or complementary investment requirements in addition to new governance (risk management) requirements. Such changes will be necessary to facilitate comparability or consolidation of financial assessment and avoid potential for regulatory arbitrage. Common requirements also facilitate the coordinated consideration of any pro-cyclical effects of regulation; and

Establishing a global solvency framework is very likely to mean the introduction of consistent risk-based requirements in addition to new governance (risk management) requirements.

- Reporting: requirements will need to be constructed to establish the collection of data and information based on consistent definitions and calibrated at common levels, so as to promote consolidated and aggregated data that is useful for the supervisors in analysing the financial condition of groups.

Qualitative aspects of solvency assessment and supervision

- Legal framework: the scope of regulation will all be reviewed including, treatment of non-regulated holding companies/entities; the extent of supervisory powers and authority; information exchange and confidentiality requirements, including insolvency laws;
- Risk management: it is very likely that risk management functions will receive even greater attention particularly for large groups, which tend to be more centralised. Common requirements for the supervisory assessment of such centralised functions, which encourage the improvement in those risk management functions rather than impose differential (and sometimes conflicting) requirements in individual solo entity, are likely to be required. Formalising the role of a Chief Risk Officer may also be contemplated to accompany other similar function holders such as those applying to Actuaries;
- Governance requirements: it is possible that requirements for fit and proper persons, outsourcing arrangements, internal auditor, external auditor and actuarial functions will be strengthened. Requirements in respect of the relationship between, and necessary independence of, directors between entities within a group, are also likely to receive increased attention;

What are the implications?

- Complex group structures, including holding company structures, will come under particular regulatory focus. Supervisors may have difficulty in clearly understanding the structure of complex groups and the linkages between different parts of the business which could have significant impacts in terms of solvency, intra-group transactions and tax treatment for different group entities may not be clear for them to understand.
- Overly complex group structures may also make the management of the group more difficult which could hamper effective communication and coordination of activities. Group management will need to demonstrate that they have a full understanding of all risks occurring in each entity as well as across the group.
- Supervisors are increasingly worried that complex structures may lead to inappropriate decisions and ineffective implementation of strategies in relation to individual entities resulting potentially in duplication, inefficiencies and additional costs.
- Financial, reputational or operational risks at the centre may expose other group entities. Conversely, some risks may crystallise at entity level and could flow through to other entities and/or the wider insurance group (contagion risks). Insurance groups need to be fully aware of such risks and ensure they are adequately prepared.
- At legal entity level, some subsidiaries may be insignificant within a group context, yet could be significant entities in their own right within their local markets. Potential conflicts of interest could arise.

- Cooperation/information exchange: Supervisors will strengthen cooperative mechanisms such as Memoranda of Understanding, establishment of supervisory colleges and group-wide assessments; and
- Non-regulated entities: requirements are likely to ensure that all relevant entities are monitored and supervised in an appropriate way, proportionate to the risks they are facing and/or that can be transmitted to entities within the group and to avoid potential for regulatory arbitrage between jurisdictions. Such considerations will need to be given to both quantitative (including intra-group transactions) and qualitative (such as reputation) risks.

It is therefore evident that insurance regulation is facing enormous change and will present significant challenges to both supervisors and insurers. However, like most regulatory changes, early

awareness and action by insurers should enable adequate opportunity to engage and influence the likely direction of insurance regulation that is adequate and proportionate to the needs of insurers, thus enabling forward-thinking and proactive insurers to gain a competitive advantage.

European Union

Solvency II will also encourage cooperation between regulators within Europe, the EEA, the IAIS and directly with third party countries through the supervision of cross-border groups. One of the most significant elements of Solvency II is the mandatory creation of supervisory colleges, whereby the various national supervisors responsible for a group and its subsidiaries can cooperate and exchange information.

Groups will have a dedicated 'group' or 'lead' supervisor, with powers and responsibilities to organise the supervision of a multi-national group.

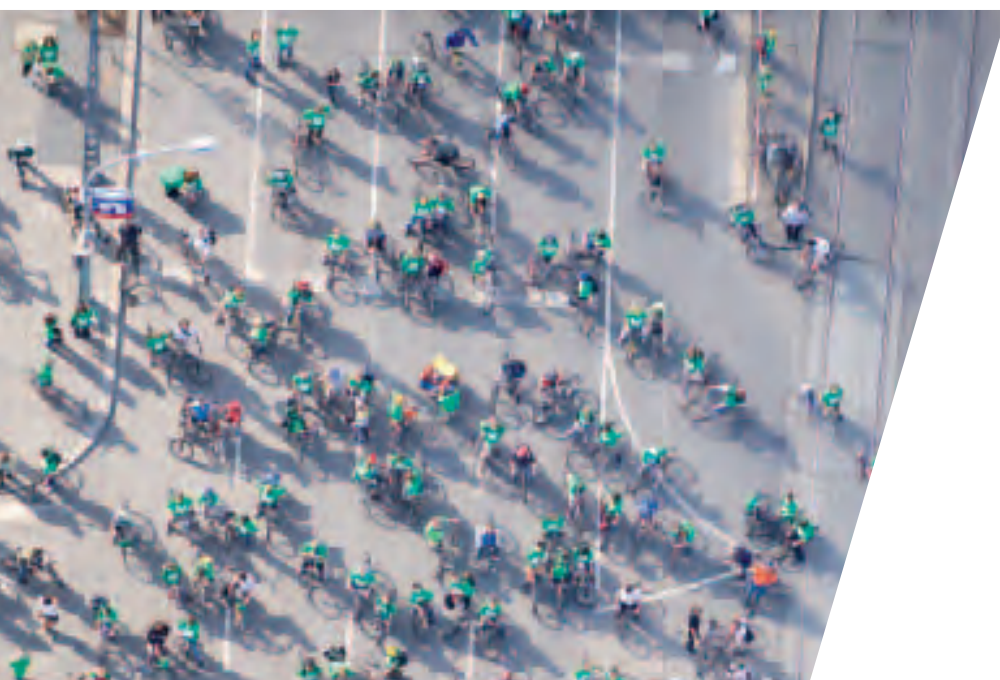
Early awareness and action by insurers should enable adequate opportunity to engage and influence the likely direction of insurance regulation.

The group supervisor will work with other supervisors to set the capital requirement, authorise any group internal model; and effectively act as the lead supervisor of the group.

North America

The US risk-based solvency regime, post the Solvency Modernisation Initiative (SMI) reforms currently underway, is likely to provide the US with a good platform for seeking equivalence with Solvency II. It is early days for US solvency reform, but US authorities are keen to reduce regulatory arbitrage and the financial crisis has increased the focus on international standards and cooperation – evidenced by proposals to create the Federal Insurance Office (FIO) that can more easily interface with international bodies like the IAIS.

To what extent US solvency requirements become harmonised with international standards and regimes such as Europe's Solvency II framework, will depend largely on the outcomes of the SMI programme. There are also questions over how the EU would negotiate and assess the equivalence of each of the 50 states. It is possible that certain state regulators could agree equivalence with the EU, or individual member states, although this is not currently believed to be an option for the



EU. The FIO is more likely to be used as the primary gateway.

The NAIC has indicated that US supervisors would be prepared to explore harmonisation with regimes like Europe's Solvency II, but they are not yet convinced that replicating Solvency II would be in the best interests of US policyholders.

Following its spring 2010 meeting, the NAIC reaffirmed US state supervisors' desire to converge solvency systems internationally, 'where practicable.' However, the NAIC also recognised that business cultures are different around the world, which might result in different regulatory systems. The NAIC are therefore keen to pursue convergence where the regulatory measures are outcomes-based rather than rules-based.

US state regulators also recognise the need to improve group solvency, and agree that a group capital assessment should be performed, although not necessarily a group solvency calculation such as a RBC.

The risk sensitive solvency frameworks of Canada and Bermuda also make them potential candidates to seek equivalence with Europe, although they would most likely have to either make or finalise adjustments to their regimes.

Issues to consider

It is clear the GFC has caused and will continue to apply pressure on supervisors in their assessment of insurance groups and their operations. This increased scrutiny and focus means insurers and insurance groups need to be actively considering the shape of their business:

- Does the Board understand the implications of changes in supervisory tone and approach?
- How well is the group able to 'wall off' exposure to certain volatile risks from other parts of the group or to maximise fiscal positions?
- Can the group centre provide group entities with better sources of financing and increase their financial security?
- How well is the group able to transfer risks between entities within the group?
- Is the group able to capitalise on making group-wide technical resources, including enhanced skills and expertise at the corporate centre, such as asset management, pricing, ERM and the management of complex or major risks available to group entities?
- Is the group able to achieve the benefits of enhanced risk and capital management expertise across the group?
- Does the group structure provide enhanced services to customers, such as enhanced risk management coverage for products and services, that avoid coverage gaps?
- Do you have an adequate and appropriate relationship with your supervisor – do they really understand your business?
- Is management information and data sufficiently comprehensive and flexible to meet multiple supervisory requirements?
- Have you up-scaled staff and compliance capability to monitor and respond to changing rules and relationships?
- Are you sufficiently engaged in developments to ensure appropriate frameworks are established?

Perspectives: Americas

Advancing transparency and supervision

US

Europe is certainly not alone in undertaking major regulatory reform. The National Association of Insurance Commissioners (NAIC) is currently looking at ways to improve solvency regulation.

The NAIC, which is not a regulator, acts as a forum for the insurance supervisors of 50 US states. It has a process to develop model insurance regulation and provide guidance on best practices, however, it remains for each state to decide whether to pass each model law or regulation, and each state may make changes in the enactment process. The NAIC assists implementation of minimum standards by assisting State regulators harmonise requirements across the US.

The NAIC has established a Solvency Modernization Initiative Task Force (SMI) which will recommend areas of improvement for the US solvency framework, and in doing so is looking at risk-based capital requirements, group solvency regulation, ORSA, corporate governance, risk management, statutory accounting and financial reporting and reinsurance.

Following the NAIC Spring 2010 meeting in Phoenix, Arizona, the SMI reported that the RBC requirements implemented in the 1990s were still held to be a necessary component of US solvency regulation, but refinements would be considered to the formula. More advanced methods such as modelling would continue to be introduced for risks where factor-based methods were not sufficient.

The SMI is the largest reform of the US regulatory system since the introduction of RBC. In response to international developments, primarily the solvency and group changes is within the IAIS and in Europe with Solvency II.

One of the most significant changes being examined is the introduction of an

ORSA, whereby insurers will have to perform their own assessment of risk and capital in addition to new mandatory stress tests. It is expected that the US ORSA will also require an examination of how risks are managed across the group and include insurance and non-insurance entities within the assessment.

Another significant feature of the SMI project is the Life and Health principles-based reserving initiative, which will include a new principles-based framework to value insurance liabilities. This will allow insurers more flexibility, based on their own internal model inputs, than that allowed under the required reserve methodology.

The SMI changes are also likely to include enhancements to the present RBC requirements, by introducing a specific confidence level and time horizon (most likely to be a tail value-at-risk (TVaR) measure. Such reforms will complement the extensive financial disclosure requirements already in existence.

Accompanying these new proposals is a greater focus on group solvency requirements, where the NAIC refer to a 'windows and walls' approach – using a 'wall' to ensure policyholder protection is maintained around legal entities and a 'window' to look at how intra-group needs are accommodated across the group.

Canada

Canada's insurance industry held up well in the financial crisis, with no failures or government-funded rescues for any financial institutions. In response to the increasing complexity of insurance products and a more dynamic economic environment, the country was a relatively early adopter of a risk-based approach to solvency, overhauling its framework for life insurers in the 1990s and then again for non-life insurers in 2003.

It is expected that the US ORSA will also require an examination of how risks are managed across the group and include insurance and non-insurance entities within the assessment.

Similar to the Solvency II 'transparency' principle, the Canadian regime has for several years required insurers to publically disclose their risk-based regulatory capital levels. Insurers are also required to run future scenario testing of capital adequacy for a range of adverse underwriting and financial markets developments, such as catastrophic losses, rapid or slow growth in premiums, and variations in interest rates and equity market prices.

One regulatory reaction to the financial crisis has been to expand the requirements for stress testing from an annual formal report to a program of regular and continuous stress testing throughout the year.

The Canadian regime has also allowed limited use of an insurer's own capital model as an alternative to the standard model, with regulatory approval, for the risk of certain investment return guarantees for segregated funds. This option is expected to be expanded in future years to apply to overall regulatory capital, similar to the approach under Solvency II.

While there were no insolvencies as a result of the financial crisis, the near failure of some overseas insurers with significant Canadian operations has heightened the Canadian regulator's interest in international regulatory standards and cooperation. The Canadian



regulator already participates in the IAIS and is likely to consider developing its regime to be more in line with Solvency II in the future.

As for Pillar 2, since 1990 the Office of the Superintendent of Financial Institutions (OSFI) has required insurers to undertake prospective scenario testing now known as Dynamic Capital Adequacy Testing (DCAT). However the DCAT does not have to be incorporated into the insurer's risk management process. It is expected that OSFI will need to review their requirements given the adoption of the new solvency IAIS standards, in particular the ORSA requirements. In regards to Pillar 3 type measures, OSFI has for the past six years required life insurers to publicly disclose analysis of gains and losses (earnings) by source. The new IFRS income statement is proposed to be similar in orientation. In addition, new disclosures under IFRS would further strengthen the Canadian requirements.

Bermuda

As the home to one of the world's largest international insurance and reinsurance markets, Bermuda has been revamping its solvency framework and will be one of the first to seek regulatory equivalence with Solvency II.

The Bermuda Monetary Authority (BMA) has also embarked on a modernisation plan, with a particular focus on regulatory harmonisation. In its 'roadmap' published in April 2009, the regulator set out plans to achieve mutual recognition or equivalence with key international markets, in particular with Europe's forthcoming Solvency II regime.

Seeking equivalence with Europe

The BMA has set out plans for a new risk-based solvency regime with all the hallmarks of Solvency II, including recognition of internal models, own risk and solvency assessments, increased

transparency and group supervision. All key elements of the new risk-based solvency regime are due to be implemented this year.

So what are the main changes?

While the present BMA capital adequacy requirements are broadly consistent with IAIS requirements, the BMA is considering adoption of a market consistent balance sheet for solvency purposes. It is yet to be determined whether the final position will be one that is based on general purpose financial statements, with prudential filters and disclosure of market consistent values (where such statements do not include fair values) for analytical purposes, or whether the entire balance sheet will comprise economic values. Meanwhile the Bermuda Solvency Capital Requirements/approved internal models are designed to establish a level of safety of 99 percent TVaR over a one year time horizon with full run-off of insurance liabilities.

In addition, the Insurance Code of Conduct 2010 (pertaining to all insurers) and the Insurance Groups Code of Conduct require many similar features to Solvency II and the IAIS ORSA. For example, insurers are required annually to develop policies, processes, and procedures to assess their material risks and self-determine the capital requirement they need to support their insurance activities. Risk and solvency assessments (contained in the Commercial Insurer's Solvency Self-Assessment) must be an integral part of the group's risk management framework, including active liquidity management and stress and scenario tests. Results must be clearly documented, reviewed, and evaluated regularly by the Board and senior management to ensure appropriateness of the risk management framework and

for any changes in market developments and/or strategy. Appropriate oversight processes must also be in place to monitor any material deficiencies and ensure they are being reported on a timely basis with suitable actions being taken. Fit and proper tests of key individuals overseeing and performing the assessment also apply which includes third-party service providers assisting with assessment procedures.



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Bermuda has been revamping its solvency framework and will be one of the first to seek regulatory equivalence with Solvency II

08



Systemic risk

The impact of global coordination

Much discussion about systemic risk all too often has been dominated by developments in the banking sector. The global financial crisis raised serious concerns internationally about financial regulation, exposing failings in systemic risk management, a lack of coordination between supervisors and insufficient regulation of complex financial services groups. It also raised awareness among politicians of the need for international regulatory convergence and cooperation on financial market regulation.

Following the G20 Summit in London in April 2009, and the Pittsburgh summit in September 2009, leaders of the world's 20 largest economies publically acknowledged the need for greater consistency and cooperation between countries. They also confirmed the need for a framework of internationally agreed high standards of financial regulation.

The G20 members determined a blueprint for reforming the regulatory framework of the financial sector, and requested that the Financial Stability Board (FSB) embark on a major program of financial reforms. Much of the G20 agreement is focussed on the banking sector; however many of the initiatives also apply to insurance. Insurance supervisors have been asked by the FSB to consider whether insurers, or insurance business itself, poses a systemic risk to the financial stability of markets.

All G20 members agreed to implement international financial standards and enhance the openness and transparency of the financial sector. Among the immediate actions called for by the G20 was the establishment of supervisory colleges for 'significant' cross-border firms, and tasking the FSB to tackle the 'too big to fail' problems associated with Systemically Important Financial Institutions (SIFIs).

The G20 also asked the appropriate bodies – the IAIS for insurance – to review the 'differentiated nature of regulation' in the banking, securities and insurance sectors and recommend improvements. In response, the Joint Forum of the IAIS, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissioners (IOSCO) concluded that it is necessary to address inconsistencies in supervisory frameworks across the banking, securities and insurance sectors in order to ensure a sounder financial system in the future.

Major systemic risks and failures in the financial sector were exposed when problems in a section of the US housing market quickly spread to financial institutions around the world, triggering the GFC.

The G20 committed to take steps to "ensure the soundness of systemically important institutions" and to extend

What are the implications?

- Considerable debate is still occurring within the insurance industry regarding the extent that insurers may pose systemic risks.
- Contagion effect is perhaps the biggest differentiator between the banking and insurance sectors, and why many insurers believe measures being contemplated for banking are not appropriate to insurers, such as the need to prepare 'Living Wills'.
- Prudential supervision, now clearly defined with a macro and micro focus, is dominating the creation of new supervisory structures.
- Increased focus on stress and scenario tests. Reverse stress tests likely to prevail as the main supervisory tools that will be used by insurance supervisors to monitor the extent of systemic risk within the system.
- Enhanced reinsurance analysis will be undertaken by the IAIS to monitor counterparty exposures.
- Lack of harmonised rules across global insurance supervisors as regards to capital will continue to apply pressure for further reforms such as the IAIS's ComFrame initiative.

regulation and oversight to all "systemically important financial institutions, instruments and markets."

Since the summit, the FSB has been working with the IAIS, the BCBS and the IOSCO to identify weaknesses in the financial system, and consider changes to prudential regulation and corporate governance principles in an effort to address systemic risk.

As part of this work, G20 finance ministers and central bank governors have endorsed a definition of systemic risk developed by the FSB and International Monetary Fund:

"The risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy."

The FSB uses three criteria to assess the systemic risk presented by an institution:

- Size: "The volume of financial services provided by the individual component of the financial system"

- Interconnectedness: "Linkages with other components of the system"
- Substitutability: "The extent to which other components of the system can provide the same services in the event of a failure"

When providing feedback to the FSB, the IAIS recommended adding a fourth criterion, that of time. According to the IAIS, the speed of loss transmitted to third parties is of particular relevance to insurance, as insurance claims, unlike banking obligations, do not immediately generate cash outflows.

The IAIS also notes that the distinct business model of insurance means that the policy solutions for systemically risky activities will likely differ between sectors, and that it will work with the FSB to develop an appropriate policy response that is applicable to insurers.

A recent study by the Geneva Association, a think tank supported by 80 insurance industry Chief Executive Officers, concluded that when applying the FSB criteria to the main activities of

insurers and reinsurers, the activities of insurers – namely investment management, providing protection and guarantees, risk transfer and capital management – do not pose a systemic risk.

The association argued that the activities of insurers do not pose a relevant systemic risk because of:

- Their limited size;
- The slow speed of their impact, which allows insurers to absorb them; and
- Features of their interconnectedness mean that contagion risk would be limited.

“Principle-based group supervision applied to all entities within an insurance group, supported by sound industry risk management practices, will mitigate potential systemic risk related to these activities. Solvency II represents such a comprehensive and economic based regulatory framework.”⁴

Insurers are also concerned that they could be included in IMF proposals to tax banks and pay for future bailouts.

Views of the IAIS

After much consideration and consultation, the IAIS considers that:

- The traditional insurance business model is unlikely to give rise to insurers posing a systemic risk.

However, other parts of the financial sector may cause the insurance sector to be susceptible – although impact to the real economy is most unlikely;

- Effective regulation and supervision can mitigate instances where insurers could amplify instances of systemic risk, such as de-risking of equity portfolios in unfavourable economic conditions or instances where capacity has been withdrawn after an event such as 9/11;
- Non-insurance activities, particularly by non-regulated entities of financial conglomerates could give rise or heighten systemic risk. In addition, certain insurance business such as financial guarantee insurance could also amplify risks and may even contribute to contagion risk across sectors or for conglomerates; and
- Between sectors, greater independencies may result in the future and therefore increased efforts will be given to resolvable issues through a greater focus on group-wide supervision, improving risk management within insurers and undertaking macro-prudential surveillance to ascertain the likelihood and potential for systemic risk to build up across jurisdictions globally.

European Union

Following the GFC, the EU announced plans to reform the regulatory framework at a European level and create a new systemic risk body.

In response to ‘uneven and often uncoordinated’ European regulation, the European Commission (EC) proposed to replace the existing three supervisory

The traditional insurance business model is unlikely to give rise to insurers posing a systemic risk.

4. Source: Special Report of The Geneva Association Systemic Risk Working Group.

committees for insurance, banking, and securities with new macro and micro regulatory bodies. The proposals have now created a macro-prudential supervisor, the European Systemic Risk Board (ESRB), and a micro-prudential supervisory framework, the European System of Financial Supervisors (ESFS).

The ESFS will consist of a network of national financial supervisors working alongside three new European supervisory authorities, created by the transformation of existing Committees for the banking securities and insurance and occupational pensions sectors. For the insurance sector, this has seen CEIOPS evolve into the European Insurance and Occupational Pensions Authority (EIOPA).

The creation of EIOPA is expected to bring about further convergence of regulations and consistency of insurance supervision in the EEA. The body will have greater powers than CEIOPS when drafting technical proposals and will be able to ensure agreement and coordination between national regulators when supervising cross-border groups.

North America

Title V of the Dodd-Frank Act establishes a Federal Insurance Office (FIO) within the Department of the Treasury that is intended to function in an advisory capacity to the Financial Stability Oversight Council (FSOC) with regard to systemic risks in the insurance industry (firms and products). The FSOC is

consulting with the industry on the criteria for assessing non-bank institutions, such as insurers, as systemically important. The FIO can make recommendations to the FSOC as to which insurers may be included.

The impact of being deemed systemically significant is not yet fully known. However, such an assessment is likely to lead to increased regulatory scrutiny, increased capital requirements, the prospect of having to produce a living will and increased reporting requirements.

Insurance companies may feel the impact of the FIO through its coordination with the US on insurance matters of national and international importance, its systemic risk focus, and through legislation and/or regulation that results from the FIO's recommendations.

ASPAC

While both insurers and insurance supervisors acknowledge the need for greater cooperation between regulators, we do not yet see significant impetus in the region for the development of 'super-regulators' and supra-national standards of regulation.

The impact of being deemed systemically significant is not yet fully known. However, such an assessment is likely to lead to, increased regulatory scrutiny, increased capital requirements, the prospect of having to produce a living will and increased reporting requirements.



09

ComFrame

Moving forward

In 2008 the IAIS embarked on an ambitious and, at the time, controversial project to explore medium to longer term options for the development of a supervisory framework for Internationally Active Insurance Groups (IAIGs) – known as ComFrame.

Although the genesis of ComFrame preceded the GFC of September 2008, the financial crisis nonetheless brought into sharp focus the global prudential requirements of systemically important insurance groups. As developments have progressed, it is now considered that ComFrame will form the substantive response by the IAIS to the G20, FSB and other international fora which are seeking responses to the macro-prudential and financial stability issues currently being sought from financial market supervisors.

Objectives of ComFrame

In constructing the parameters for ComFrame, the IAIS articulated the following objectives:

- Operationalise group-wide supervision for IAIGs in order to better align supervisory practices with the (good practice) trans-national approaches IAIGs actually apply in doing business;
- Comprehensively address group-wide risks and establish better supervisory cooperation in order to allow for an integrated approach amongst supervisors; and
- Foster global convergence of regulatory and supervisory measures and approaches.

The founding principles for ComFrame are to:

- Become the multilateral tool of preference for assessing IAIGs;
- Provide meaningful value to both home and host supervisors for undertaking group supervision;
- Be specific, but not rules-based;
- Be ever-evolving (and further look into case experiences);
- Be developed in close collaboration with interested stakeholders; and
- Lead to more consistency and better comparability and alignment regarding the supervision of internationally active insurance groups being undertaken by each jurisdiction.

ComFrame will cover not only quantitative aspects, such as a common solvency assessment, but also qualitative and legal aspects, including investment, ERM and other risk management issues. The ComFrame is split into five modules:

- 1 Scope of application
- 2 Group structure and business
- 3 Quantitative and qualitative requirements
- 4 Supervisory cooperation and interaction
- 5 Jurisdictional matters

Each module is then divided down into further elements. For example, module 3 will address elements related to quantitative and qualitative requirements including quantitative methodologies such as valuation and capital adequacy (including internal models), qualitative methodologies including corporate governance and internal controls and methodologies that may include both qualitative and quantitative aspects including ERM and regulatory investment requirements.

A concept paper is due by July this year and depending on developments, it is then envisaged that a formal development phase over the next three years thereafter will develop the actual requirements of the new framework. A calibration and quantitative impact assessment stage is not expected to occur until year three of the project.

What are the benefits for industry?

ComFrame should, in time, provide a range of benefits for insurers by:

- Becoming the multilateral framework for assessing internationally active insurance groups, enhanced cooperation and recognition amongst insurance supervisors. This should result in consistent outcomes for the measurement of solvency and related requirements including capital determinations. Such measures should allow supervisors to gain increased confidence in the supervisory methods applied, allowing a lead supervisor of the group to make informed decisions. In turn, this should reduce the amount of duplication and allow groups to have

common world-wide risk and capital platforms. Such an environment should go a long way to answering many of the financial stability issues currently being debated.

- Consistent measurement of solvency measures such as valuation, capital adequacy, ERM, investment and internal model criteria should reduce costs significantly. A common platform of requirements will provide insurance groups with enhanced capabilities for managing and measuring the insurance group's capital, solvency and risk positions (particularly in regards to technical provisions, risk margins and internal models). It will also avoid having duplicative systems and requirements at the local level. This should facilitate better investor and analyst communication and enhance shareholder value.
- Better supervisory understanding of the operations of insurance groups should reduce the inefficiencies and frictional costs for IAIGs arising from supervisors being unable to fully comprehend the complexities of large multi-national insurance groups and groups being able to better explain the risks and opportunities provided by group structures. Boards and senior management will be able to have confidence in integrating the full suite of modelling techniques to their risk management framework.

A common set of requirements should provide IAIGs with the ability to:

- Demonstrate the quality of senior management and oversight of risk management by outlining: how current and possible future risks are managed and contained in the particular business model; how risk appetite measures are incorporated; and the subsequent impact on capital resources available;

- Maximise efficiencies: by applying consistent methodologies to capital management; possibly providing for the consistent application of diversification benefits; and allowing enterprise risk management frameworks to be fully integrated with economic capital models;
 - Outline the robustness and appropriateness of their group-wide ORSA;
 - Better implement a consistent fit-for-purpose governance and internal control framework;
 - Streamline reporting across the group – both public and private reporting including audited and non-audited information; and
 - Develop robust business analysis and information tools for world-wide application.
- Cost of undertaking different risk, capital and governance change programmes
 - Different admissibility/asset and investment restrictions relating to capital requirements
 - Differences in reinsurance arrangements to accommodate different jurisdictional requirements
 - Statutory form filings and related reporting and disclosure requirements
 - Internal management, senior management and Board engagement spent on compliance and regulatory issues
 - External auditor requirements
 - Additional technical input (such as accounting, risk and actuarial advice)
 - Peer reviews
 - Collateral requirements
 - Cost of supervisory colleges and regulatory compliance more generally
 - Different compensation scheme requirements
 - Consultancy, rating agencies, trade associations and other service providers used to input, support, or involved with global and local insurance activities.

Current costs of regulation and supervision

The cost of having different regulations poses significant detriment to shareholder value, creates competitive distortions and inefficiencies and gives rise to regulatory arbitrage issues. These costs of sovereign and reputational risks in the marketplace are ultimately borne by consumers and policyholders generally.

The additional cost in meeting these requirements for IAIGs, in the absence of harmonised and converged requirements, both as measured by direct and indirect costs, are significant. The additional costs associated with both prudential and market conduct requirements arise via the opportunity cost of capital from having to meet different jurisdictional needs and subsequent costs incurred to group models, structures and functions. Such costs comprise:

- Direct compliance personnel and administrative costs

These costs do not include future cost impositions on IAIGs in the form of living wills and recovery and resolution schemes currently being examined by supervisors.

We have had a number of discussions with our clients and estimate that such costs to the sector globally are considerable – and could range from US\$15bn–\$25bn. By any measure such costs are significant. In our view, the industry needs to insist that the regulatory changes result in a predictable, stable and well defined architecture; that there is consistency in application across the different jurisdictions; and the outcomes will serve stakeholders interests – both investors and customers – well.

Issues to consider

- How aware are you of the ComFrame developments? Early involvement and participation now during the policy formulation stage is needed by all industry participants to ensure an effective and appropriate framework that is outcomes focussed.
- Does your business have the technical skills that will be required from industry to provide support and assist supervisors in their deliberations?
- Even though ComFrame is in the early development phase, what data and system changes would be likely for your group in order to capitalise upon the envisaged framework?

The cost of having different regulations poses significant detriment to shareholder value, creates competitive distortions and inefficiencies and gives rise to regulatory arbitrage issues.

A global perspective

KPMG's network of Regulatory Centres of Excellence at the heart of the major financial markets – US, Europe and ASPAC – delivers cross-border insights in response to the unprecedented scale and impact of regulatory change.

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Visit www.kpmg.com/regulatorychallenges for more discussions on the regulatory issues facing the financial services industry.

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Produced by KPMG's Global Financial Services Practice in the UK.

Designed by Mytton Williams

Publication name: Evolving Insurance Regulation

Publication number: 314617

Publication date: March 2011