Insurance Practice Group
ALERT

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Global Insurance Body Issues Draft Framework for Regulation Including Capital Adequacy

On October 17, 2013, the International Association of Insurance Supervisors issued a draft of its Common Framework ("ComFrame") for the Supervision of Internationally Active Insurance Groups ("IAIGs") for consultation and public comment, with a deadline for comments of December 16, 2013. The draft is available at http://www.iaisweb.org/index.cfm?-pageID=1128.

Publication of the draft ComFrame follows the IAIS's announcement earlier this month that it would be developing a global standard for assessing insurance risk-based capital (expected to be completed by 2016). This recent IAIS activity also coincides with ongoing efforts among U.S. policymakers and regulators to change the way that *domestic* insurers' capital and solvency are regulated, presenting some instructive parallels as well as contrasts between the two regimes.

Under ComFrame insurance regulators will generally be required to impose the following main "elements" of supervision[1] on IAIGs:

- Regulation of "legal and management structures," with an emphasis on cross-border risks that are less likely to exist in insurers operating in a single country.
- Oversight of corporate governance including the expected roles of the IAIG's board or other governing body, management and other actors.
- Enterprise Risk Management ("ERM") standards, addressing all "relevant and material" group risks, leading to a calculation of an IAIG's solvency requirements.

[1] ComFrame, p. 3.

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- Specific components of ERM including an investment policy, an underwriting policy, a claims management policy, a reinsurance strategy, an insurance liability valuation policy and an actuarial policy.

- Capital adequacy regulation.

With respect to the last item, capital adequacy, ComFrame would require international insurers to determine a capital "benchmark" as a measurement of adequacy of total capital, taking into account risks (including risk concentrations) comprising insurance risk, market risk, credit risk, group risk and operational risk. The benchmark is to be established using a "scenario-based" approach.[2] To evaluate the asset side of the enterprise, ComFrame would require an IAIG to identify and quantify its eligible assets (referred to as "qualifying capital resources" ("QCRs")) and to measure these against the applicable benchmark. ComFrame divides QCRs into two tiers, "core" capital and "additional" capital, based on ability to absorb losses both "on a going-concern [basis] and in a winding-up."[3] Loss-absorption is measured according to criteria such as permanence, availability, subordination and absence of both encumbrances and mandatory servicing costs.

Although ComFrame is only a preliminary statement of the capital-adequacy principles being developed by IAIS, some initial points of comparison with the U.S. framework are instructive.

Historically U.S. insurance companies have been governed by the National Association of Insurance Commissioners ("NAIC") risk-based capital ("RBC") regime, which yields an "authorized capital level" for each insurer and establishes multiples of that level as thresholds warranting varying degrees of regulatory intervention. More recently the NAIC has introduced more group-based tools as part of its Group Solvency Initiative, requiring companies and their affiliates to self-examine and report enterprise-wide risks. However, these do not necessarily incorporate a quantitative or statistical tool for measuring capital adequacy. In addition, for domestic insurers that are either affiliated with depository institutions or designated as "systemically important" entities, there is a concern that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[4] could impose on these insurers still *other* risk-based capital standards that are more appropriate for banks, augmenting or even displacing state-law RBC standards. (Although U.S. policymakers have indicated varying degrees of willingness to address this issue, the Federal Reserve Board of Governors has yet to finalize its capital standards for such companies, leaving the insurance sector in a state of some uncertainty.)

The IAIS's ComFrame differs from the typical approach of U.S. regulators in at least three ways:

- The IAIS's approach for measuring capital adequacy is more comprehensive than the U.S. approach insofar as the IAIS standards appear intended (i) to harmonize capital adequacy reporting across a given insurance group and (ii) to differentiate insurance RBC from bank RBC.

- The IAIS's classification scheme of "core" versus "additional" capital (apparently based on Basle III standards for banks) does not appear to be as robust as the treatment afforded to investment assets under state RBC. As the IAIS develops its quantitative guidance in the coming months,

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[2] *Id.*, p. 85

[3] *Id.*, p. 68.

[4] P.L. 111-203.

- we expect this classification scheme to evolve in order to take account of the wide diversity in insurance company investment portfolios.

- ComFrame, which combines quantitative and discretionary elements, seems to chart a middle course between the heavily quantitative approach of U.S. insurance RBC and the more subjective approach used in the NAIC's newer group-supervision models.

With the IAIS capital standard in its infancy, and Dodd-Frank and NAIC measures evolving slowly, it is not clear how these multiple regimes will be able to co-exist easily in an increasingly global insurance marketplace. But it is clear that ComFrame represents a significant development in international financial supervision, likely to have an impact for years to come.

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