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Systemically Important Financial Institutions—An Insurance Perspective

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BACKGROUND

Systemically Important Financial Institutions (SIFI) are defined as "Financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. To avoid this outcome, authorities have all too frequently had no choice but to forestall the failure of such institutions through public solvency support. As underscored by this crisis, this has deleterious consequences for private incentives and for public finances." The global financial crisis of 2008 brought to the fore the debate on "too big to fail." The crisis highlighted the costs of supporting systemically important financial institutions as well as the linkages both, between institutions as well as across countries. This prompted the , a group of the largest economies in the world, to come together and debate measures that needed to be taken to prevent recurrence of such problems. The tasked the Financial Stability Board (FSB) along with international regulatory associations such as the Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO) to evolve frameworks for supervision of such SIFIs.

The mandate to the FSB included identification of criteria for determination of SIFIs, reviewing and suggesting modifications to current regulatory frameworks. It also included developing a model to deal with such failures in a way that normal financial activity is not disrupted. The FSB, since then, has brought out discussion papers and policy proposals to address the mandate. These models in essence seek to identify problems with Systemically Important Financial Institutions even before they become statutorily insolvent and also put in place a framework that could be adopted to deal with such instances in an orderly fashion.

Some important outcomes of these deliberations have been the publication of a comprehensive paper on Key Attributes of Effective Resolution Regimes for Financial Institutions, FSB, October 2011, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement, BCBS, October 2011 and Intensity and Effectiveness of SIFI Supervision, FSB, October 2011. The FSB also published a progress report which contains a section from the IAIS covering developments in the Insurance industry.

DEVELOPMENTS IN THE INSURANCE DOMAIN

In November 2010, the Financial Stability Board (FSB), in consultation with the International Monetary Fund (IMF), released a report on Intensity and Effectiveness of SIFI Supervision (the SIE report). The SIE report observed that prior to the crisis, risk management processes at SIFIs were generally judged to be acceptable, but the crisis indicated otherwise. The report noted that supervisory work was often not geared "outcomes" but more focused on process and noted that supervisory expectations for SIFIs in particular needed to be augmented. The SIE report did not set out new supervisory rules and policies for SIFIs but set out 32 recommendations for making the supervision of financial institutions more intense, effective and reliable.

In September 2011, the International Association of Insurance Supervisors (IAIS) released a report on implementation of recommendations for enhanced supervision of insurance companies. The IAIS, through its member bodies which are national insurance regulators, provides a globally accepted framework for the supervision of insurance entities through a set of principles called the Insurance Core Principles (ICP). The IAIS report sets out changes that need to be made to these ICPs given the recommendations emanating from the SIE report.

The areas covered are as below:

1. Mandates

Mandates cover what the responsibilities and powers of the supervisor need to be. The report seeks to strengthen the need for primary legislation to clearly define the objectives and responsibilities of the supervisor. It also requires that supervisors have the authority and ability to intervene early enough to address a potential problem.

2. Independence

This essentially deals with requirements for the supervisor to be independent from the other stakeholders including governments, executive, judiciary as well as industry.

Notable changes include guidance that the supervisor should not manage or otherwise have any operational role in the functioning of the insurers that it supervises. It also seeks to address potential conflict of interest situations for members of the governing body of supervisors.

3. Resources
This primarily addresses the need for supervisors to have adequate staffing both in terms of number and quality to ensure the effectiveness of the supervisory process.

To address this, guidance and requirements have been added to the principles to ensure:

- adequate allocation of resources for both on-site and off-site monitoring
- processes are established to assess the potential systemic importance of insurers depth and quality of staff to support effective supervision given the nature, scale and complexity of the supervised entities
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It also adds guidance to address resource planning, skill enhancement including assignments in industry or across regulators and flexible hiring policies so that staff is better aligned to industry practices.

4. Supervisory Powers
The section on Mandates also addresses the point of Supervisory powers.

5. Improved Techniques
a) Focus on Outcomes
As discussed earlier, one of the key comments in the SIE report was the need to focus on outcomes in addition to focusing on processes. The IAIS now seeks to bring in greater focus on outcome assessment through various principles and guidance related to enterprise risk management and the need for the supervisor to validate that the assessment of risks for different lines of business is appropriate. The objective is also to evaluate the level of capitalization required to deal with a range of stress scenarios for each supervised entity.

b) Horizontal Reviews
Horizontal reviews deals with the need to use information collated from various other sources in addition to normal submissions, including qualitative and quantitative information, to ascertain the state of affairs at the supervised entities.

c) Assessment of Boards
Changes have been made to emphasise the governance structures including the Board to ensure that systemically important entities are managed with a rigour which is commensurate with their importance in the system.

d) Financial Statement Analysis
Guidance has been added to ensure that supervisors promptly analyse financial information received from insurers so that they develop a deeper understanding of emerging trends affecting an insurer, its risk appetite and the effectiveness of its strategy.

e) Business Models and Product Analysis
No changes are considered necessary in this area.

f) Quantitative Models outside Pillar 1
The intent is to further discuss the use of internal models for regulatory risk assessment and it is expected that further guidance will be provided.

g) Stress tests
No additional changes are required in this area.

h) Data Aggregation
The changes cover the need to actively review information requirements for regulatory submission as well as the need to build ability at the supervisor level for building architecture to capture and analyse this information in a timely fashion.

i) State of the Art Controls including risk management
There has now been a requirement added that supervisors develop an appropriate response commensurate with the nature and degree of the risk associated with systemically important insurers.

6. Group and Consolidated Supervision
The IAIS 2011-2012 roadmap includes a self-assessment exercise on the ICPs related to group supervi-

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sion with a completion date of spring 2012. The work will be undertaken by the Standards Observance with subject matter expertise provided by the relevant working parties responsible for developing the ICPs.

The roadmap also includes an exercise to develop specific mechanisms that facilitate of solvency information. Work will be undertaken by the Solvency and Actuarial Issues Subcommittee and supported by the Insurance Groups and Cross Sectoral Subcommittee. The development phase will run through to September 2012 with facilitation due for completion by October 2013.

7. Continuous and Comprehensive Supervision
One of the key areas that is sought to be addressed is that there should be continuous communication at senior levels between the supervisor and the supervised entities to continually keep track of developments in the business and industry.

8. Supervisory Colleges, Home/Host
The IAIS 2011-2012 roadmap includes a review and update of the Supervisory College Guidance paper, providing additional guidance for a range of situations involving large, complex institutions which would also be applied to potential SIFIs.

The IAIS has conducted an impact assessment survey of the guidance paper on the use of supervisory colleges supervision. The IAIS is organising regional roundtables with group and host supervisors as well as the relevant insurance groups; preparing a questionnaire on colleges and organising presentations from members with experience in colleges. The information collected will be used to assess the need to review and update the Supervisory College Guidance paper. A report will be completed by end-2012.

The IAIS repository of supervisory colleges (IROSC) is currently being set up under a joint project between the Insurance Groups, Cross Sectoral Subcommittee and the Supervisory Cooperation Subcommittee.

9. Macro-prudential surveillance, Multi-disciplinary approach (forward looking)
Some of the aims of macro prudential surveillance and regulation are to: i) Identify systemic risk (including shocks, interconnectedness and feedback effects), ii) Reduce the likelihood of systemic risk, and iii) Mitigate spill over effects within the financial system and into the real economy. Consistent with this, the focus is now significantly on forward looking analysis and review to facilitate identification of potential problems early and allow interventions that can address such problems.

10. Use of third parties
Supervisors typically call upon third parties for specific assignments to supplement their supervisory work. The ICPs now highlight the need for control and ownership of all such third party use by the supervisor.

11. Concluding Recommendations
The revised ICPs will be assessed based on standards and there will be no additional criteria.

The introduction to the ICPs includes the following statement:
"It is recognised that supervisors need to tailor certain supervisory requirements and actions in accordance with the nature, scale and complexity of individual insurers. In this regard, supervisors should have the flexibility to tailor supervisory requirements and actions so that they are commensurate with the risks posed by individual insurers as well as the potential risks posed by insurers to the insurance sector or the financial system as a whole. This is provided for in the ICPs and standards where relevant."

THE STANDARDS OBSERVANCE

Subcommittee is developing self assessment questionnaires in the areas of supervisory mandate, supervisory powers and group supervision. The Standards Observance Subcommittee's work plan includes the development of self assessment questionnaires for other ICP material over the next two years. A draft IAIS Peer Review Process is currently being prepared for review by the Implementation Committee and others. ■