

IAIS Technical Committee
Hearing Topic – Groups and Solvency Assessment

March 6, 2008

Session 1: Exploring the economic realities and supervisory challenges of groups

1. To what extent do insurance groups operate as a coherent economic entity – are they managed as a single entity? *For the purposes of answering this question we have presumed that a group is defined as a group of companies structured under an ultimate parent holding company where all the subsidiaries report to the group holding company. Publicly traded insurance groups are managed as a single enterprise, being held accountable by the shareholders expecting a specified return on equity (or other financial measure). Management, under the guidance of the Board of Directors, oversees the entire group and develops a common business plan applicable to the group. Individual business units within a group may be composed of one or more legal entities but they are held accountable for performance to the goals established by the group’s management and Board. . Legal entities within the group will be subject to management by their own boards, but performance and goals will be aligned with strategy developed at the group level.. There may be exceptions to this general rule that we have described, but it is important to focus on ERM and capital management as being a decision controlled by the group in a top down fashion.*
 - a. How are ERM frameworks and internal models developed and employed in an insurance group? *ERM models and internal models are developed at a group level to support overall risk management, corporate governance, overall capital allocation and other qualitative measures of performance. How do risk management and internal control systems work in a group structure? Risk management and internal control systems have to mirror the group structure and decision making process. For groups this is most often a “top down” management system with internal controls being in sync with the overall ERC framework. To be effective the risk management framework must view the group as one “economic unit”; any attempt to operate controls within a legal entity structure only weakens the overall framework.*
 - b. Are the circumstances any different when the group operates across borders, where the benefits of free movement of capital, equivalence of regulation and effective regulatory cooperation do not prevail? *The same principle would apply to group’s that function across borders of multiple jurisdictions. The ownership structure is what guides the company’s governance. Specific jurisdictional regulatory or legal requirements can affect key factors including: company structure, capital requirements, dividends, and governance. Companies incorporate regulatory requirements into their business models to ensure compliance with such*

regulations, but the same framework and models will operate irrespective of jurisdiction.

c. What is the role of the supervisor(s) where ERM and internal models are developed and employed at a group level? Our experience is that in most jurisdictions today regulators do not have authority in this area. In specific jurisdictions, where key regulators do have authority today, they review and in some cases approve ERM, models and internal controls. In some jurisdictions (as contemplated in Europe under Solvency II) regulators have review and approval requirements tied to utilization of models as an offset to regulatory required capital. The role of the supervisor is solely to review the model for compliance with its own regulatory framework or subject it to equivalency recognition to “approve” it such that other regulators can rely upon the “approval. Regulatory authority has to be clearly spelled out so that we don’t have redundant, contradictory and overlapping regulatory requirements. In other jurisdictions, where regulatory systems do not include such provisions, insurers may share such information with regulators as part of ongoing financial examinations so that regulators have a better understanding of company operations. The IAIS work on capital models establishes guidelines that perhaps will lead to a convergence of regulatory activity in the area. IAIS work that encourages regulatory knowledge of such capital models and their relevance to regulation is beneficial to the market.

2. What is the economic reality where an entity within a group is failing? An individual entity within a group may fail for many reasons. For example, an entity may fail because of: the specific business losses of the group, units that are acquired that include unforeseen problems, losses associated with the type of business or geographic concentration of business within a subsidiary, or senior management failings that may subject that entity to a greater risk including risks that are unforeseen. An individual legal entity may fail, even though the group remains healthy.

a. How do groups fail? Is it usually an entity (or entities) failing in isolation, and which is supported by the group until group resources are exhausted? For the purposes of answering this question we have assumed that “failure” is defined as either a business unit that is put in runoff as not being a going concern, or an insolvency. We believe the context here is business units failing as a going business concern where the operations are then put into solvent runoff. The business unit fails because it has lost the confidence of its customer base. Insolvency is a separate matter addressed under the Session 2 questions. Groups can fail for many reasons and we don’t believe there is any one common answer to this question. Within recent memory a large German insurer and reinsurer affords an example of where a specific type of business caused a specific unit to be closed, while the group itself reorganized to carry on or sell other business units. Other examples exist in the European market, where non European business units were put into runoff as part of a strategy to ensure the survival and successful reorganization of the parent enterprise. A French reinsurer and a Swiss reinsurer would be examples of this

successful strategy. Other examples in recent memory are groups created from merger and acquisition strategy where the business strategy of individual units or the groups was found to be wanting. In some cases the entire group was put into solvent runoff, and in other cases individual units were put into runoff while other units remained as going concerns. The mono-line bond insurers in the US market afford a real time opportunity to study groups including outcomes that could include successful on going business operations and reorganizations splitting going concern business from runoff business. Or do systemic risk management failures across the group cause the entire group to fail as an economic entity? Systemic risk management failures across the group could cause an entire group to fail, but in our collective memory it seems more often than not that individual business units failed for specific business reasons. In fact enterprise risk management systems were created to address the very point of this question. We think the case can be made the ERM frameworks largely prevent such broad based, systemic failures.

b. How do the economic concepts of group support and transferability of capital apply in situations of adversity? Does the application of these concepts vary depending on:

- i. The manner of the group's failing as in a. above? Yes, if an isolated segment of the business or non-core legal entity fails and the remainder of the group is healthy, then the group has many tools to fix the problem. Group support may not be the best choice for the affected policy holders or the policyholders of the healthy businesses in the group. Transfer of specific business to a specialized run-off company may be a better choice than adding capital to a failing business.
- ii. Whether the group operates across borders?

We note that question two contains both the phrases "group failure" and "group support." They mean two different things since group support is defined in Solvency II to be the requirement to boost capital up to the MCR level at the request of the solo supervisor. Group management has the freedom to decide whether to continue to support a troubled business unit or to close it down (or regulators can seize control of the unit under certain solvency regime provisions; or under Solvency II if the group support regime fails then regulators can reassert additional solo supervisory powers). Individual business units are expected to earn their own internal rates of return and failure to meet their group goals may be the first sign of trouble in that operation. In addition, individual entity regulatory requirements may also become a reason for management to pull the trigger and decide that the regulatory capital required can become a reason to decide to close down a business unit that is failing to perform up to its goals. Whether or not the group functions across borders should not be a primary determinant of whether the business unit gets

capital support. The unit is measured on financial performance. There may be cases of macro political or economic instability in a specific jurisdiction (economic crises in Argentina, Thailand or post war Europe, or revolution) that can affect the support of a given business unit, but those would be the exceptions and not the rule. Cross border establishments create complexity for the group decision making and regulatory/legal mechanisms are variously available in different jurisdictions, but the group needs the flexibility to make the decision on what to do with business units that are not going concerns. The lead group regulator needs to assist the group in its ability to ensure that other regulators don't interfere with this normal business process.

- c. How should the supervisor(s) deal with the enforcement of solvency requirements on individual entities and the group as a whole in situations of adversity? Some groups will choose not to apply for the group support regulatory framework. Outside of the EU with Solvency II, non EU groups will also have the ability to be outside of the group support framework. The group regulator and the subsidiary regulator should follow their specific legal mandates. The legal requirements should be the primary guide to the regulator. These legal requirements should also spell out the role for the solo regulator vis a vis the group lead regulator. Economic reality should afford the group regulator the lead role in such actions. In particular, what requirements might be imposed on the group in circumstances of capital inadequacy of an individual entity? No response. What if localized problems cannot be solved using group resources? At what point should group restructuring be considered e.g. selling profitable parts of the group? The group's management in consultation with the group regulator will have to advise on this point. Group restructuring should be solely a commercial decision for management, subject to applicable regulatory approvals. How might the approaches apply or vary when the group operates across borders? Since the management of the group governs the group without consideration to geographic boundaries, it should be recognized that the same principles should apply to regulators involved in group supervision. The legal framework governs the authority of the group's regulators and should set the standards for regulatory authority in multiple jurisdictions. In situations where, regulators of portions of the group exist outside of the cooperative group regulatory arena, it should be understood that that regulator's powers are limited to those appropriate to it as a solo entity in the group. Absent a mutual recognition framework it may be impractical to assume that the group cooperation contemplated in the IAIS papers can exist. Management should develop a strategy and work with all regulators of group companies—who will follow their respective legal mandates while recognizing the larger issue.
- d. Are there any practical issues with the non-equivalency of insolvency laws and pre-insolvency laws? Yes there are practical issues with regard to

insolvency laws, but the main focus here should be on the legal requirements created for group supervision. Most of the issues can be addressed in that framework. Insolvency laws protect creditors, regardless of whether they are creditors of a solo company or group company.

3. How should benefits of diversification (if any) within a group be reflected? *As with Solvency II, the benefits should be afforded via recognition of the group solvency capital requirement and the lowering of capital requirements for the individual solo subsidiary operations. The diversification benefit accrues to the group and it is up to company management to allocate the benefits to the capital of the various subsidiaries. It is the group, in accordance with its ERM framework, not the regulator that allocates the benefits of diversification to the various subsidiaries.*

a. Is there empirical evidence which supports the positive benefits of diversification within a group? In relation to economic capital needs, how might such benefits vary under normal circumstances, and circumstances of adversity? *We defer any response here and refer the Technical committee to the various CEA papers that have been written on the subject.*

b. To what extent should the supervisor(s), recognize diversification benefits (where shown to exist) in the solvency assessment of the group? *We support the principals of group support included in Solvency II.*

c. How may the diversification benefits available to the group (if any) be fairly and practically attributed to the subsidiary entities in assessing the extent to which the protection of the obligations to policyholders of those respective entities, and the group as a whole, are protected in the event of adverse circumstances? *The benefits of diversification flow from the group's ERM and capital model. Those frameworks will direct how the diversification benefits are allocated.*

d. Would different responses to the above questions apply for 'intra-risk' diversification (e.g. between different types of insurance risk) as compared to 'inter-risk' diversification (e.g. insurance vs. investment, investment vs. operational, operational vs. insurance). *Intra-risk diversification should be reflected within the capital model for the group and reflected in the various legal entities as appropriate.*

Session 2: Exploring the Concept of a Group Supervisory System

4. To what extent, or under what particular circumstances, do you consider each of the following to be an essential element of a group supervisory system?

a. Group supervision undertaken/coordinated by a single identified supervisor. *There will have to be a regulatory leader selected to make group supervision function. This is an essential component of effective group supervision.*

b. Group supervision supported by a collaboration of all involved supervisors (through a supervisory college or other mechanisms to promote efficient information exchange) *A regulatory college or other mechanism is an effective component of functioning of a group regulatory environment.*

Without it, it would be hard to envision enough regulatory buy in to win the cooperation needed for group regulation to be successful.

c. A defined group solvency basis – applied as if the group is a single entity. *This is an essential element of a group regulatory framework. Without it, it would be impossible to provide the benefit to the group from reduced capital support to its subsidiary operations. Trapped capital would be the result. If there is one group supervisor then there should be one group solvency basis applied at the group level.*

d. Legal certainty regarding intra-group commitments and obligations. *The general legal requirements should be defined in the legislation. How a company meets its legal obligations is up to the company. The group will need the flexibility to determine how it will meet its legal obligations. There should not be restrictions imposed in the legislation on how the company that chooses to be subject to a group regulatory framework has to comply. There are many legally enforceable means to achieve group support, reinsurance agreements, letters of support and parental guarantees. These do not need to be specified in the legislation; rather the legal standard is all that is needed. Regulators can later assert their rights to enforce the laws to compel insurer compliance.*

e. Agreed standards of solvency assessment and uniform application. *The legal framework should specify the solvency assessment standards and there should be “uniform application” of agreed upon principles.*

f. Frameworks for mutual recognition. *Across jurisdictional boundaries, a mutual recognition framework would be an essential ingredient of true group supervision. A more limited means of group supervision may be practical without some agreement.*

g. The operation of sovereign policyholder protection schemes. *It should be assumed that jurisdictions have varying policyholder protection schemes. Not all jurisdictions have such schemes. These are not an essential ingredient of a group regulatory framework. Such schemes are a matter of individual jurisdiction decisions with regard to how to protect and fund to pay policyholder claims in the event of an insolvency.*

5. On a global basis, is there sufficient:

Convergence of supervisory standards; equivalence of regulation; Compatibility of sovereign law in relation to solvency; to establish an effective international group supervisory system? *On a global basis, there would not seem to be a sufficient convergence at this time. Milestones towards that goal would include the successful implementation in Europe of Solvency II and the effective functioning of several bilateral or multiple lateral mutual recognition frameworks. These achievements will lay the foundation for a future group supervision framework.* To what extent can concepts of group solvency assessment be practically implemented in the absence of such convergence? *The first step would be to work on functioning mutual recognition agreements. Use these as the basis to study successful experiments. Convergence can follow after a successful experimentation period.*

- a.. What is needed to create the necessary momentum towards improved convergence? *Ongoing regulatory dialogue and practical experience is what is necessary to advance regulatory convergence. There needs to be broad based political support to enact such measures. Cooperation of both regulators and the industry is essential in building such broad based support.*
- b. Is the IAIS advancing the agenda at a sufficient pace, or should it be doing more to promote the international debate on group issues? *Europe seems to have taken the leadership with regard to group issues in Solvency II. Europe's practical experience with Solvency II will inform the ongoing discussion. Regulatory cooperation and mutual recognition agreements would seem to be where the current focus should be. We'd encourage the United States via the NAIC to recommend how the US can become part of an international group supervision framework. The IAIS would benefit from a timetable for moving ahead on a workable international group supervision framework.*
- c. Are there lessons to be learnt from other financial sectors – for instance the banking sector? *No comment here. We have no practical experience in the banking area to draw from.*
- d. Where a group supervisory system is founded on more advanced approaches (ERM and internal models), how do you extend this framework to facilitate the integration of emerging countries (where less sophisticated approaches are more appropriate and/or likely)? *IAIS leadership on regulatory cooperation and mutual recognition are necessary, essential actions to take to work with integration of emerging countries. Without taking such steps it is impossible to determine what regulatory practices are in place and how regulators intend to deal with regulatory compliance, capital requirements and potential group supervisory issues.* What does such a framework imply for the supervision of small/medium enterprises?
- e. Should the IAIS be developing model laws on insurance insolvency to support group supervision (i.e. sovereign insolvency laws that recognize the insolvency of a group of entities and the equivalent rights of policyholders in other jurisdictions?) *This would be an enormous burden for the IAIS to undertake. Resources would be better spent on working on regulatory cooperation, training, and completion of existing key standards in development and actual implementation of mutual recognition frameworks.*