SULLIVAN & CROMWELL LLP

December 18, 2019

IAIS—International Capital Standard, ComFrame, Holistic Framework for Systemic Risk in the Insurance Sector

IAIS Adopts Global Frameworks for Supervision of Internationally Active Insurance Groups and Mitigation of Systemic Risk in the Insurance Sector

SUMMARY

On November 14, 2019, the International Association of Insurance Supervisors ("*IAIS*") adopted at its Annual General Meeting a set of reforms that are the culmination of work the IAIS, in consultation with the Financial Stability Board ("*FSB*") and national authorities, initiated in response to the 2008 financial crisis.[1] The reforms are intended to establish supervisory standards and guidance, including a group-wide capital standard, for the effective group-wide supervision of Internationally Active Insurance Groups ("*IAIGs*") and to establish a framework for the assessment and mitigation of systemic risk in the insurance sector.[2] IAIS supervisory measures will take effect in individual jurisdictions once, and to the extent, they are enacted by national authorities, subject to implementation timeframes contained in the IAIS materials, and, once implemented, will result in significant changes to the regulatory frameworks applicable to IAIGs. In addition, since some of the associated reforms adopted by the IAIS would also apply to insurance companies and groups that are not IAIGs, these changes are expected to impact the regulation of insurance companies more broadly across jurisdictions, and may influence national insurance regulators when designing and modifying their own local capital and other regulatory frameworks.

The adopted reforms include the following key components, each of which remains subject to further monitoring, implementation and assessment actions:

International Capital Standard

The International Capital Standard ("*ICS*"), which has been in development by the IAIS since 2013, is intended to be a group-wide, consolidated insurance capital standard for application to IAIGs and is designed to enhance global convergence among group capital standards for insurers. On November 14, 2019, the IAIS adopted ICS Version 2.0 ("*ICS 2.0*"),[3] the implementation of which will be conducted in two phases: (1) a five-year "monitoring period," to begin in January 2020, during which the standard will be used for confidential reporting to group-wide supervisors (*i.e.*, national regulators) and discussion in supervisory colleges; and (2) implementation as a group-wide prescribed capital requirement ("*PCR*"). Confidential reporting will cover a "reference ICS" based on a market-adjusted valuation approach, and, at the option of group-wide supervisors, additional confidential reporting based on a "GAAP with Adjustments" approach and/or other methods of calculation. The IAIS published the "Level 1" document for the adopted ICS 2.0, which sets forth the broad principles and concepts and overall architecture of ICS 2.0. The IAIS expects to publish the "Level 2" document for ICS 2.0, which will provide technical specifications and other details for the monitoring period, in early 2020. Accordingly, many of the key details of ICS 2.0, including required adjustments, risk charges and qualifying capital tier limits, will not become available until early 2020.

In addition, the IAIS will collect data during the ICS monitoring period from the United States and other interested jurisdictions to assess whether an aggregation method ("*AM*") to group capital calculations and standards may provide comparable outcomes to the ICS. The AM differs from the ICS and other "consolidated" approaches to group capital because the AM relies on existing local capital requirement calculations and not on the creation of a single, standardized calculation at the consolidated group level. The AM achieves this by aggregating jurisdictional regulatory required capital and available capital to a single measure by scaling key metrics to a uniform basis.

ComFrame

On November 14, 2019, the IAIS adopted the Common Framework for the Supervision of Internationally Active Insurance Groups ("*ComFrame*"), which has been in development since 2010.[4] ComFrame is intended to facilitate effective group-wide supervision of IAIGs by providing qualitative and, in a future phase upon the finalization and implementation of the ICS as a group-wide PCR, quantitative supervisory minimum requirements tailored to the international activity and size of IAIGs. ComFrame builds and expands on the high-level standards and guidance set forth in the IAIS' Insurance Core Principles ("*ICPs*"), which generally apply at both an insurance legal entity and group-wide level. The ICPs apply to the supervision of all insurers within a jurisdiction, including IAIGs, whereas ComFrame builds upon the ICPs and provides additional standards and guidance specific to the supervision of IAIGs. In addition to developing ComFrame, the IAIS has been in the process of revising the ICPs over the last several years;

the ICPs and ComFrame document adopted on November 14, 2019 reflects both the agreed-upon ComFrame material and all of the ICPs as revised.

ComFrame material has been integrated into ICPs in respect of, among other topics: corporate governance; risk management and internal controls; supervisory review and reporting; preventive/corrective measures; market exits and resolution; enterprise risk management for solvency purposes; group-wide supervision; and supervisory cooperation and coordination.

Holistic Framework

The Holistic Framework for Systemic Risk in the Insurance Sector ("*Holistic Framework*"), adopted by the IAIS on November 14, 2019, consists of: (1) an enhanced set of supervisory policy measures and powers of intervention, which are embedded within certain ICPs and ComFrame material; (2) an annual global monitoring exercise; and (3) implementation assessment activities aimed at assessing and mitigating the potential build-up of systemic risk in the global insurance sector.[5] The enhanced policy measures include, among other things: on-going supervisory requirements applied to insurers, targeted at key potential systemic risk exposures such as liquidity risk, macroeconomic exposure and counterparty exposure; macroprudential supervision aimed at identifying vulnerabilities and addressing the build-up of systemic risk at both the individual insurer and sector-wide levels; and crisis management and planning, including requirements on recovery and resolution planning and the establishment of crisis management groups.

The approved framework, which is slated for implementation in early 2020, moves away from the previous binary approach, in which a set of pre-determined policy measures applied to only a small group of identified global systemically important insurers ("*G-SIIs*")[6] and, instead, "promotes a proportionate application of an enhanced set of supervisory policy measures and powers of intervention for macroprudential purposes to a broader portion of the insurance sector." The IAIS will, however, continue to use risk factors, similar to those used in the past to identify G-SIIs, to assess potential systemic risk at individual insurers as part of its global monitoring exercise and systemic risk assessment. In addition, many of the enhanced supervisory measures reflected in the Holistic Framework, which are intended to apply, depending on the supervisory measure and subject to proportionality principles, to IAIGs and other insurers, are similar to and derived from the enhanced policy measures the IAIS had formerly adopted for application to G-SIIs only.

In connection with the adoption of the Holistic Framework, the IAIS also published for public consultation, on November 19, 2019, a draft Application Paper on Liquidity Risk Management, which proposes a set of supervisory requirements relating to liquidity risk, including corporate governance aspects of liquidity risk management, liquidity stress testing, liquidity portfolio requirements, contingency funding plans, and liquidity risk management reporting.[7] The IAIS also previously published a draft Application Paper on Recovery Planning[8] and intends to produce application papers on Macroprudential Supervision and Resolution Powers and Planning in 2020.

BACKGROUND

The IAIS and FSB

The IAIS, established in 1994, is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions, constituting 97% of the world's insurance premiums. U.S. members of the IAIS include the U.S. Treasury's Federal Insurance Office ("*FIO*"), the National Association of Insurance Commissioners ("*NAIC*"), state insurance regulators and the Board of Governors of the Federal Reserve System ("*FRB*"). Although the policy measures and financial reforms promulgated by the IAIS have no legal force unless enacted at the relevant jurisdictional level, the regulatory authorities of members' jurisdictions have committed to implement policy measures promulgated by the IAIS, taking into account specific market circumstances, and to undergo periodic self-assessments and peer reviews with respect to their implementation.

The FSB consists of representatives of national financial authorities and central banks of the G20 nations, various international standard-setting bodies (including the IAIS), as well as the International Monetary Fund and the World Bank. The U.S. members of the FSB include the FRB, the Securities and Exchange Commission and the Department of the Treasury. Since its establishment in 2009, the FSB, in conjunction with the G20 and related governmental bodies, has developed various proposals to address issues such as financial group supervision, capital and solvency standards, systemic economic risk, corporate governance, effective resolution regimes, and related issues associated with responses to the 2008 financial crisis. The FSB consults with the IAIS with respect to insurance sector matters.

ICPs and ComFrame

The ICPs were first issued in 1997 and substantially revised in response to the financial crisis in 2011, and have been subject to periodic revision since that time. The ICPs reflected in the materials adopted in November 2019 reflect prior ICP consultations and revisions; however, ICP 14 (Valuation) and ICP 17 (Capital Adequacy) will continue to be reviewed following adoption of ICS 2.0 and may be further revised in light of ICS implementation.[9] ICPs are intended to apply to insurance supervision in all IAIS member jurisdictions regardless of the level of development or sophistication of the insurance markets and insurance supervision. ICPs are structured to allow for a wide range of supervisory approaches and processes to suit different markets. ComFrame, on the other hand, provides additional, and generally more prescriptive, standards and guidance on top of the relevant ICPs and has been tailored with the intention of providing more coordinated guidance across jurisdictions to address the complexity and international activity of IAIGs. ComFrame began development in 2010 and has been the subject of multiple public consultations, stakeholder meetings and field testing. In 2016, the IAIS decided to integrate the presentation of ComFrame material directly into the ICP structure, such that the ICPs and ComFrame now belong to one document and follow the same hierarchy of "*Principle Statements*," "*Standards*" and "*Guidance*."

The ICPs and ComFrame are expected to be implemented and applied in accordance with a "proportionality" principle, allowing ICP and ComFrame material to be translated into a jurisdiction's supervisory framework in a manner appropriate to its legal structure and market conditions, and allowing supervisors to increase or decrease the intensity of supervision according to the risks specific to insurers or a jurisdiction's insurance sector, and to tailor supervision through a variety of supervisory techniques in order to achieve the ICP or ComFrame outcomes.

ICS and Insurance Group Capital Standards

In October 2013, the IAIS announced its plan to develop a risk-based global insurance capital standard in response to the request by the FSB that the IAIS produce a work plan to create a comprehensive group-wide supervisory and regulatory framework for IAIGs. According to the IAIS, the ultimate goal is to develop a single ICS that includes a common methodology by which one ICS achieves comparable, *i.e.*, substantially the same, outcomes across all jurisdictions. The IAIS has conducted a multi-year quantitative field testing process with "Volunteer Insurance Groups" (composed of both IAIGs and other insurance groups), and has produced a number of public consultations and held various stakeholder meetings on the ICS. Once finalized, the ICS is intended to be a minimum standard for a group PCR for IAIGs. Because the ICS is a group-wide, consolidated insurance capital standard, however, it is not intended to be a legal entity requirement or to affect or replace existing capital standards for legal entity supervision in any jurisdiction.

In November 2017, at its Annual Conference in Kuala Lumpur, the IAIS announced a unified path to convergence of group capital standards and acknowledged the development of the AM within the United States. Although the AM is not part of ICS 2.0, the IAIS is developing criteria to assess whether the AM provides comparable outcomes to the ICS, starting with a project plan intended for delivery by the end of the ICS monitoring period. According to the IAIS, comparable outcomes or "outcome-equivalence" to the ICS means that the AM "would produce similar, but not necessarily identical, results over time that trigger supervisory action on group capital adequacy grounds."

Development of the ICS and other IAIS measures in response to the financial crisis occurred at generally the same time as financial regulatory reform initiatives at the domestic and regional level. For example, in the European Union ("*EU*"), the Solvency II Directive (2009/138/EEC) ("*Solvency II*"), which was initially developed in 2009 and became effective on January 1, 2016, includes minimum capital and solvency requirements, governance requirements, risk management and public reporting standards applicable to insurers operating in the EU, as well as group-wide supervision and solvency standards. These standards may be applied to insurance groups that are headquartered outside the EU but that have EU operations. The ICS, like Solvency II and unlike the AM, follows a "consolidated approach" for group-capital standards, and bears other similarities to Solvency II (*e.g.*, market-based valuation of insurance assets and liabilities and the tiering of qualifying capital resources).

In the United States, the NAIC and U.S. state insurance regulators have been developing, and are in the process of field testing, a group capital calculation ("*GCC*") for use in insurance group solvency-monitoring activities for U.S. insurance groups. The GCC, which is expected to be completed by Summer 2020, is a risk-based capital ("*RBC*") aggregation approach (*i.e.*, a type of AM), whereby available capital resources and required regulatory capital are aggregated from the various individual entities comprising the group, including U.S. and non-U.S. entities. To aggregate entities whose capital requirements may differ from U.S. RBC, the GCC proposes to apply scalars to adjust available capital and capital requirements.[10]

At the U.S. federal level, passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*") in 2010 expanded the FRB's supervisory role to include primary supervisory responsibility over savings and loan holding companies ("*SLHCs*") and their non-depository subsidiaries, including over SLHCs significantly engaged in insurance activities ("*Insurer SLHCs*"), and over any non-bank financial companies designated as systemically important ("*SIFIs*") by the Financial Stability Oversight Council ("*FSOC*"), including SIFIs primarily engaged in insurance activities ("*Insurer SIFIs*"). (No firms are currently designated as Insurer SIFIs.) In September 2019, the FRB issued a notice of proposed rulemaking that would establish capital requirements for Insurer SLHCs, and could in the future apply to Insurer SIFIs if any are designated. The proposed capital framework, termed the "Building Block Approach" or "BBA," is also a form of AM and is designed to adjust and aggregate existing legal entity capital requirements into a group-level capital framework for Insurer SLHCs.[11]

The NAIC, FIO, FRB and U.S. state insurance regulators—known as "*Team USA*"—have been critical of the ICS framework and requested that the IAIS recognize the AM as an outcome-equivalent approach in the ICS 2.0 release.[12] Among other things, Team USA and members of the U.S. Congress have expressed concern that the market valuation approach typified in the ICS will be excessively volatile and may undermine the ability of insurers to offer certain types of annuities and life insurance and other long-term products. The IAIS aims to be in a position by the end of the ICS 2.0 monitoring period to assess whether the AM provides comparable outcomes to the ICS.[13] On November 14, 2019, the FIO registered its official objection to the IAIS' advancement of ICS 2.0 into the monitoring period, noting that "U.S. insurers should not face pressure to participate in a reference ICS that is not expected to apply in the United States and does not fit [domestic] markets" and arguing that the "current form of the ICS could also risk limiting U.S. consumers' access to important long-term saving products."[14] Moreover, according to the NAIC's interpretive guidance on the AM comparability assessment, U.S. IAIGs will not be required to participate during the monitoring period with respect to the reference ICS but may report on the reference ICS and/or the AM during the monitoring period based on discussions with the applicable group-wide supervisor.[15]

Holistic Framework and Systemic Risk

In addition to the ICPs and ComFrame, the framework developed by the IAIS following the financial crisis included a third tier of supervisory actions and requirements, G-SII Policy Measures, intended to apply only to those insurance groups designated as G-SIIs. G-SIIs were defined by the FSB and IAIS as insurers whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity. The FSB, in consultation with the IAIS and national authorities, designated G-SIIs on an annual basis starting in 2013 and through 2016, based on a G-SII Assessment Methodology developed by the IAIS. In February 2017, the IAIS announced a shift in its approach with the development of an activities-based approach to mitigate systemic risk in insurance, in contrast to the entity-based approach that had formed the basis of the IAIS' G-SII Assessment Methodology and annual identification of G-SIIs. In light of the IAIS development of an activities-based approach to systemic risk, the FSB decided not to publish a list of G-SIIs for 2017, and has not done so since. In November 2018, the IAIS issued a public consultation document proposing the Holistic Framework.[16] As noted, in November 2022, the FSB will review the need to either discontinue or re-establish an annual identification of G-SIIs based on the initial implementation of the Holistic Framework.

A parallel designation process took place in the United States pursuant to Dodd-Frank, which authorizes the FSOC to designate, and subject to FRB supervision, non-bank financial companies that the FSOC determines "could pose a threat to the financial stability of the United States." The FSOC previously designated four SIFIs, three of which were Insurer SIFIs, but each such designation has since been rescinded. On December 4, 2019, the FSOC issued amendments to its interpretive guidance on designating SIFIs.[17] The guidance, which replaces the FSOC's interpretive guidance on SIFI designations issued in April 2012, implements an activities-based approach to identifying and addressing potential risks to financial stability, with the FSOC pursuing entity-specific determinations (*i.e.*, SIFI designations) "only if a potential risk or threat cannot be addressed through an activities-based approach," and represents a parallel shift by the FSOC away from entity designations as the primary tool for managing systemic risk.

The IAIS' G-SII Policy Measures were published in 2013. The G-SII Policy Measures included: enhanced group-wide supervision, with group-wide supervisors to have direct powers over holding companies and the power to impose restrictions and prohibitions on certain activities; enhanced capital standards, including "basic capital requirements" applicable to all group activities and, for certain businesses and activities, "higher loss absorption capacity requirements"; systemic risk management plans for managing, mitigating and possibly reducing systemic risk; enhanced liquidity planning and risk management; and effective crisis management and resolution regimes applicable to G-SIIs. In light of the suspension of G-SII designations, these G-SII measures are no longer applicable to any entities. However, the Holistic Framework integrates certain elements of the G-SII Policy Measures into the revised ICPs and ComFrame material. Accordingly, these measures are applicable, subject to the "proportionality principle" set forth in ComFrame and the ICPs, to a much larger set of insurers than those insurers that were identified as G-SIIs in the past.

INTERNATIONAL CAPITAL STANDARD

The ICS is intended to be a consolidated group-wide capital standard for IAIGs. Implementation of ICS 2.0 will be conducted in two phases:

- A five-year monitoring period, during which ICS 2.0 will be used for confidential reporting to group-wide supervisors and discussion in supervisory colleges; followed by
- implementation of the ICS as a group-wide PCR. The IAIS defines PCR as "a solvency control level above which the supervisor does not intervene on capital adequacy grounds."[18]

Confidential reporting will cover a reference ICS, which is based on a Market-Adjusted Valuation approach ("*MAV*"), and, at the option of group-wide supervisors, additional confidential reporting based on a GAAP with Adjustments approach ("*GAAP Plus*") and/or other methods of calculation of the ICS capital requirement, including internal models. Prior to the adoption of the ICS as a PCR, there will be a public consultation and the IAIS will undertake an economic impact assessment.

The documentation framework for the monitoring period consists of three document levels: (1) the Level 1 document sets out the overarching principles and concepts of ICS 2.0; (2) the Level 2 document, which the IAIS expects to publish in early 2020, will provide more detailed specifications regarding ICS 2.0; and (3) the Level 3 documentation, to be issued in the second quarter of each year during the monitoring period, will provide additional information to enable annual confidential reporting. The "Technical Note on ICS Version 2.0 for the monitoring period" ("*ICS Technical Note*"), published as part of the ICS 2.0 package, includes a table summarizing technical changes to ICS 2.0 compared to the IAIS' 2019 field testing specifications;[19] according to the Technical Note, components not described therein will use the same approach as that set forth in the 2019 field testing specifications, although it is possible the Level 2 document may include additional technical modifications.

ICS calculations and requirements are subject to certain guiding principles set forth in ICS 2.0, including:

- *Substance over form*. The economic substance of transactions and events, rather than just their legal form, is recorded on the ICS balance sheet, which may result in differences from publicly reported GAAP financial statements (*e.g.*, certain assets on a GAAP balance sheet do not qualify as assets for the ICS). In addition, insurance liabilities are allocated to the segment or business line that best reflects the nature of the underlying risks rather than the legal form of the insurance contract. Insurance line of business segmentation details will be specified in the Level 2 document.
- *Proportionality*. Specific ICS factors or rules may be ignored or simplified where the IAIG can demonstrate that such factors or rules would lead to a significant increase in complexity without material improvement to the quality of the relevant calculation or assessment of risk.

- *Look-through*. The IAIS intends to apply, where possible, a look-through approach in order to assess the risks of the assets underlying collective investment funds and other indirect exposures, additional guidance on which will be provided in the Level 2 document.
- *ICS rating categories*. The Level 2 document will provide guidance on the rating categories (ranging from 1 to 8) the ICS has developed for purposes of the ICS and how the ICS rating categories map to existing credit rating agency ratings. ICS rating categories are employed in connection with calculating certain risk charges used in determining the ICS capital requirement.[20]

A. REFERENCE ICS

The reference ICS is a consolidated group-wide standard for IAIGs, intended to be a going-concern measure of capital adequacy, that is comprised of three components: (1) MAV (market-adjusted valuation); (2) criteria for qualifying capital resources; and (3) the standard method for the ICS capital requirements. The reference ICS coverage ratio is calculated as:

ICS Ratio = Qualifying Capital Resources / ICS Capital Requirement

Perimeter of the ICS

The ICS starts with the audited consolidated GAAP balance sheet of the insurance holding company of an insurance group or financial holding company of a financial conglomerate. If an insurer does not prepare audited consolidated GAAP financials, statutory financial statements will be aggregated to reflect the group level starting balance sheet (the Level 1 document does not provide details on this process).[21] The audited GAAP balance sheet is then split into two components: (1) entities that are insurers or whose purpose is insurance related; and (2) non-insurance entities (details on which entities are considered insurance or non-insurance related will be found in the Level 2 document). The non-insurance entities are "reported separately" from insurance entities, on a GAAP basis, with certain exceptions to be described in the Level 2 document. Non-insurance entities (financial and non-financial) are "incorporated" into the reference ICS, based on the entity type and whether or not the entity is subject to a sectoral capital requirement. The capital requirement for financial non-insurance entities is based on the entity's sectoral capital rules, if available (*e.g.*, bank capital requirements). The Level 2 document will describe the capital requirement for financial non-insurance entities without sectoral capital rules and for non-financial entities. However, for all entities, whether insurance or non-insurance entities, the criteria for qualifying capital resources will follow the framework set out for the reference ICS.[22]

Market-Adjusted Valuation (MAV)

The starting MAV balance sheet is comprised of the insurance and insurance related entities only (*i.e.*, excluding non-insurance entities and exposures), subject to adjustments. MAV is based on the amounts as reported on audited, consolidated, general-purpose GAAP or Statutory Accounting Principles ("*SAP*") accounts, and includes adjustments (described in part below but also subject to other adjustments to be set forth in the Level 2 document) to: (1) insurance liabilities and reinsurance balances; (2) financial investments (assets) and financial instruments (liabilities); and (3) deferred taxes.[23]

MAV insurance liabilities are the sum of a "current estimate" and a "margin over current estimate" ("*MOCE*"), unless such liabilities are replicable by a portfolio of assets.[24]

Current estimates. The current estimate corresponds to the probability-weighted average of the present values of the future cash-flows associated with insurance liabilities or reinsurance recoverables, discounted using the ICS yield curve relevant for the currency and bucket of each liability (described below). The current estimate does not include any implicit or explicit margins and does not take into account the IAIG's own credit standing. Requiring insurance liabilities to be recorded based on the present value of expected future cash flows using current discount rates effectively translates insurance liabilities to a market-based valuation, as opposed to book values or other measures used in some statutory accounting frameworks, such as SAP, that place more emphasis on the long-term nature of life and annuity contracts and appropriate asset-liability management strategies. Details on how to project cash flows for the current estimate calculation will be provided in the Level 2 document.

With respect to contract recognition and "contract boundaries,"[25] a contract is recognized when the IAIG becomes a party to the contract and the contract continues to be recognized until all obligations related to it are extinguished, such that the current estimate should cover the full lifetime of all the cash flows required to settle the obligations related to recognized insurance and reinsurance contracts at the valuation date. The current estimate calculation may recognize management actions where the management actions are objective, realistic and verifiable, and not contrary to applicable law or the IAIG's obligations to policyholders. The Level 2 document will provide further details on contract boundaries, management actions, and requirements relating to data quality and modeling assumptions.

In order to calculate a current estimate, insurance liabilities are discounted using an adjusted risk-free yield curve intended to provide a consistent discounting approach across jurisdictions. The ICS adjusted yield curve is based on: (1) risk adjusted liquid interest rate swaps or government bonds, *i.e.*, the risk-free yield curve, which is determined by means of a three-segment approach that employs a stable currency specific long-term forward rate (LTFR) and spread adjustments, and (2) an adjustment to the risk-free curves determined by means of a "three-bucket approach."[26] Details on the discounting approach and methodology will be further specified in the Level 2 document. By applying a discount to insurance liabilities to reflect the time value of money, insurance liabilities will be to some extent interest-rate sensitive, even where interest rate changes may have no direct impact on the valuation of expected insurance claims. This has led many commenters to criticize the MAV approach as introducing unnecessary volatility and pro-cyclicality to the valuation of insurance liabilities.

MOCE. MOCE is a margin added to the current estimate "in order to achieve a market-adjusted value of insurance liabilities." MOCE is intended to cover the inherent uncertainty in the cash flows related to insurance obligations. MOCE is calculated as a given percentile of the normal distribution characterized by: (1) a mean equal to the current estimate of insurance obligations; and (2) a 99.5% percentile equal to the relevant life or non-life risk charge. The percentiles for life and non-life insurance normal distributions will be specified in the Level 2 document. Under ICS 2.0, current estimates only (excluding MOCE) will be subject to stress-based calculations for determining the pre- and post-stress net asset values, such that MOCE would "remain constant" during the stress. In addition, MOCE is neither deducted from the ICS capital requirement nor added to qualifying capital resources.[27]

Qualifying Capital Resources

Qualifying capital resources are determined on a consolidated basis and are comprised of: (1) qualifying financial instruments and (2) capital elements other than financial instruments, each of which are subject to adjustments, exclusions and deductions. Any item deducted from capital resources is to be excluded from the calculation of the ICS capital requirement. As a general matter, ICS 2.0, as a consolidated capital calculation, assumes that capital within an insurance group is fully fungible and interchangeable across entities within the group. ICS 2.0 contains, however, special rules with respect to mutual IAIGs and accepts certain types of contractual and structural subordination as permissible forms of subordination for purposes of qualifying capital resources, subject to conditions and requirements to be set forth in the Level 2 document.[28]

The ICS identifies two tiers of capital:

- Tier 1 capital resources: financial instruments and capital elements other than financial instruments that absorb losses on a going-concern basis and in winding-up; and
- Tier 2 capital resources: financial instruments and capital elements other than financial instruments that absorb losses only in winding-up.

Financial instruments. The classification of financial instruments into tiers is based on five key principles: (1) loss absorbing capacity (on a going-concern basis and/or in winding-up); (2) subordination; (3) availability to absorb losses (*i.e.*, the extent to which the capital element is fully paid and available for absorption of losses); (4) permanence; and (5) absence of both encumbrances and mandatory servicing costs. Within each tier, financial instruments are allocated into two categories with differing qualifying criteria:

- Tier 1:
  - Tier 1 financial instruments for which there is no limit (Tier 1 Unlimited)
  - Tier 1 financial instruments for which there is a limit (Tier 1 Limited)

- Tier 2:
  - Paid-up Tier 2 financial instruments (Tier 2 Paid-Up)
  - Non-paid-up Tier 2 financial instruments (Tier 2 Non-Paid-Up)

The table below, based on a table in the Level 1 document, provides an overview of the differences between the tiers (other than Tier 2 Non-Paid-Up items, which are restricted to mutual IAIGs).

Key Principles	Tier 1 Unlimited	Tier 1 Limited	Tier 2 Paid-Up
Loss absorbing capacity	Absorbs losses on both a going-concern basis and in winding-up	Absorbs losses on both a going-concern basis and in winding-up	Absorbs losses in winding-up
Level of subordination	Most subordinated (*i.e.*, the first to absorb losses); subordinated to policyholders, other non-subordinated creditors and holders of Tier 2 capital instruments and holders of Tier 1 Limited capital instruments	Subordinated to policyholders, other non-subordinated creditors and holders of Tier 2 capital instruments	Subordinated to policyholders and other non-subordinated creditors
Availability to absorb losses	Fully paid-up	Fully paid-up	Fully paid-up
Permanence	Perpetual	Perpetual For mutuals, this requirement is considered to be met if redemption (for a dated instrument) can be deferred, subject to supervisory approval or a lock-in feature, subject to a sufficiently long initial maturity No incentives to redeem permitted Issuer may redeem after a minimum specified period after issuance or repurchase at any time, subject to prior supervisory approval[29]	Sufficiently long initial maturity – may have incentives to redeem but first occurrence deemed to be "effective maturity date"
Absence of encumbrances and mandatory servicing costs	IAIG has full discretion to cancel distributions (*i.e.*, distributions are non-cumulative) The instrument is neither undermined nor rendered ineffective by encumbrances	IAIG has full discretion to cancel distributions (*i.e.*, distributions are non-cumulative) The instrument is neither undermined nor rendered ineffective by encumbrances	The instrument is neither undermined nor rendered ineffective by encumbrances

With regard to Tier 2 Paid-Up capital, the form of subordination may be either contractual or structural, although structurally subordinated instruments will be subject to certain conditions. The recognition of Tier 2 Non-Paid Up capital is restricted to mutual IAIGs only, and once such items become paid-up, the resulting capital element must possess the features required of Tier 1 or Tier 2 Paid-Up capital resources, as applicable.[30] The list of criteria and conditions associated with each tier of capital will be specified in the Level 2 document.

Capital elements other than financial instruments. Capital elements other than financial instruments ("*Other Capital Elements*") are allocated into two tiers:

Tier 1 Other Capital Elements include the following items:

- retained earnings;
- share premium resulting from the issuance of financial instruments included in Tier 1, and other forms of contributed surplus earned from sources other than profits;
- accumulated other comprehensive income ("*AOCI*");
- the fair market value of equity-settled employee stock options, as long as a corresponding expense is recorded in the profit and loss account of the IAIG; and
- "other allocated to equity," which includes minority/non-controlling interests and adjustments applied to the IAIG's consolidated balance sheet to produce the ICS balance sheet.

The following items are deducted from Tier 1 Other Capital Elements, subject to netting requirements respecting deferred tax liabilities ("*DTLs*") and deferred tax assets ("*DTAs*"):

- goodwill;
- intangible assets, including computer software intangibles;
- assets relating to a defined benefit pension fund;
- DTAs;
- reciprocal cross holdings, arranged either directly or indirectly between financial institutions and that "artificially inflate" the IAIG's Tier 1 capital position;
- direct and indirect investments in the IAIG's own Tier 1 capital instruments that have not otherwise been eliminated;
- reinsurance assets "arising from arrangements deemed to constitute non-qualifying reinsurance" (*i.e*., reinsurance agreements with entities that are neither regulated nor subject to risk-based solvency supervision or that do not provide sufficient transfer of risk);
- encumbered assets in excess of the on-balance sheet liabilities secured thereby; and
- the value of equity and debt owned by the IAIG in entities that are excluded from the scope of the group.

Tier 2 Other Capital Elements include the following items:

- share premium resulting from the issuance of financial instruments included in Tier 2 Paid-Up capital resources;
- in respect of assets and liabilities excluded from Tier 1, the value of encumbered assets in excess of on-balance sheet liabilities secured thereby; and
- a Tier 2 basket comprised of proportions of specific items deducted from Tier 1 (value of defined benefit pension funds net of any eligible DTL; any DTA deducted from Tier 1 capital resources; and the value of computer software intangibles (net of amortization) deducted from Tier 1 capital resources, net of any eligible DTL).

The Tier 2 basket is subject to a limit, to be expressed as a percentage of the ICS capital requirement. The proportions of the three items included in the Tier 2 basket and the overall limit applicable to the basket will be specified in the Level 2 document.

The following items are deducted from Tier 2 Other Capital Elements: (1) reciprocal cross holdings that "artificially inflate" the Tier 2 capital position of the IAIG; and (2) direct and indirect investments in the IAIG's own Tier 2 capital instruments, that have not been otherwise eliminated.

Capital composition limits. The Tier 1 Limited and Tier 2 capital resources after adjustments, exclusions and deductions are subject to limits, to be expressed as a percentage of the ICS capital requirement. The limits, which may differ depending on whether the IAIG is a mutual or non-mutual company, will be specified in the Level 2 document. Tier 1 Limited capital resources that are in excess of the limit are eligible for inclusion within Tier 2 capital resources, and become subject to the limit applicable to Tier 2 capital resources. According to the Technical Note, the Tier 2 basket has been increased in comparison with prior ICS 2.0 field testing technical specifications from 10% to 15% of the ICS capital requirement, and the calculation of the amount of computer software intangibles recognized in the Tier 2 basket has been changed to reflect a 90% haircut (as opposed to the prior 50% haircut).

The Standard Method

The reference ICS standard method for determining ICS 2.0 capital requirements consists of the following risks: (1) insurance risk; (2) market risk; (3) credit risk; and (4) operational risk. The table below, based on a table in the Level 1 document, lists the risk categories and the individual risks in each risk category. The ICS capital requirement is based on "the potential adverse changes in qualifying capital resources resulting from unexpected changes, events or other manifestations of the specified risks." The ICS target criterion is a 99.5% Value at Risk (VaR), over a one-year time horizon, of adverse changes in the IAIG's qualifying capital resources. Except for natural catastrophe risks, for which a stochastic or other vendor model approach may be used, risks are to be measured using either a stress approach or a factor-based approach. The stress approach follows a dynamic approach using the IAIG's current balance sheet pre-stress and the IAIG's balance sheet post-stress; changes in net asset value under the stresses are then used as a proxy for changes in qualifying capital resources. The factor-based approach is determined by applying factors to specific exposure measures.

Risk / Sub-risk	**Scope (*i.e.*, risk of adverse change in the value of capital resources due to types of risk specified)**	**Factor-based**	**Stress**
Insurance Risks			
• Mortality risk	Unexpected changes in the level, trend or volatility of mortality rates		X
• Longevity risk	Unexpected changes in the level, trend or volatility of mortality rates		X
• Morbidity/Disability risk	Unexpected changes in the level, trend or volatility of disability, sickness and morbidity rates		X
• Lapse risk	Unexpected changes in the level or volatility of rates of policy lapses, terminations, renewals and surrenders		X
• Expense risk	Unexpected changes in liability cash flows due to the incidence of expenses incurred		X
• Premium risk (non-life)	Unexpected changes in the timing, frequency and severity of future insured events (to the extent not already captured in Morbidity/Disability risk)	X	
• Claims reserve risk (non-life)	Unexpected changes in expected future payments for claims or events that have already occurred (whether or not reported to the IAIG) and not yet fully settled (to the extent not already captured in Morbidity/Disability risk)	X	
• Catastrophe risk**	Unexpected changes in the occurrence of low frequency / high severity events		
Market Risks			
• Interest rate risk	Unexpected changes in the level or volatility of interest rates		X
• Non-default spread risk	Unexpected changes in the level or volatility of spreads over the risk-free interest rate term structure, excluding the default component		
• Equity risk	Unexpected changes in the level or volatility of market prices of equities		X
• Real estate risk	Unexpected changes in the level or volatility of market prices of real estate or from the amount and timing of cash flows from investments in real estate		X
• Currency risk	Unexpected changes in the level or volatility of currency exchange rates		X
• Asset concentration risk	The lack of diversification in the asset portfolio	X	

Risk / Sub-risk	Scope (*i.e.*, risk of adverse change in the value of capital resources due to types of risk specified)	Factor-based	Stress
Credit Risk	Unexpected changes in actual defaults as well as in the deterioration of an obligor's creditworthiness short of default, including migration risk and spread risk due to defaults	X	
Operational Risk	Operational events including inadequate or failed internal processes, people and systems, or from external events; includes legal risk, but excludes strategic and reputational risk	X	

** Uses vendor modeling approach

The ICS capital requirement recognizes the effect of risk mitigation techniques (*e.g.*, collateral, guarantees and credit derivatives, among other techniques), subject to specific criteria, conditions and caps to be set forth in the Level 2 document. ICS risk charges are aggregated together, and combined in a manner intended to recognize risk diversification, by means of multiple aggregation levels and correlation matrices, which will be specified in the Level 2 document.

Tax

Deferred taxes, as recognized on the consolidated GAAP or SAP balance sheet, as applicable, are also recognized on the ICS balance sheet. Two areas of the ICS are tax-affected: (1) differences in valuation between the jurisdictional consolidated balance sheet and the ICS balance sheet; and (2) the ICS insurance capital requirement. ICS 2.0 is structured to apply a top-down approach using a group effective tax rate ("*ETR*") to calculate the deferred tax on the ICS-adjusted consolidated balance sheet and the tax effect on the ICS insurance capital requirement. The method to calculate the group ETR will be specified in the Level 2 document. The adjustments made to the GAAP/SAP balance sheet will give rise to corresponding adjustments to DTAs and DTLs, subject to utilization assessments, conditions and adjustments to be specified in the Level 2 document.

B. ADDITIONAL REPORTING

At the option of the group-wide supervisor, IAIGs may submit additional reporting during the monitoring period based on GAAP Plus valuation and/or other methods of calculation. GAAP Plus and other methods of calculation will be considered for inclusion in the ICS by the end of the monitoring period.

GAAP Plus

GAAP Plus is intended to maximize the use of existing audited, consolidated financial reporting, systems and processes. Since some jurisdictional accounting rules relating to insurance are subject to significant on-going developments (*e.g.*, new accounting rules under IFRS and U.S. GAAP relating to the valuation of insurance liabilities or long-duration contracts), development of GAAP Plus is expected to continue beyond 2020. Additional reporting based on GAAP Plus for IFRS, U.S. GAAP and Chinese GAAP was included in prior field testing and will continue development and field testing into the monitoring period; GAAP Plus additional reporting for Japanese GAAP will begin in 2020. Further details on the reporting of GAAP Plus will be provided in the Level 2 document.

Other Methods

Other methods that will be permitted for additional reporting during the monitoring period, at the option of the group-wide supervisor, are: (1) internal models; (2) dynamic hedging; and (3) "supervisor-owned and controlled credit assessment processes" ("*SOCCA*"). A SOCCA process is "an independent and objective process for assessing credit risk, owned and controlled by a financial supervisory authority, and that relies upon credit assessment methodologies deemed suitable by the supervisory authority in determining the regulatory capital requirement for credit risk of supervised entities." The Level 1 document specifies NAIC credit designations as an example of a SOCCA. A decision will be made by the end of the monitoring period whether any of the other methods will be included in the implementation of ICS as a PCR. The scope for additional reporting of other methods during the monitoring period will be limited to the ICS capital requirement, *i.e.*, valuation and criteria for qualifying capital resources will not be affected. Other methods are intended to provide the same level of protection as the standard method, *i.e.*, a target criterion of 99.5% VaR over a one-year time horizon.

C. AGGREGATION METHOD – COMPARABILITY ASSESSMENT

Although the AM is not part of ICS 2.0 nor deemed outcome-equivalent thereunder, the IAIS will collect data from the United States and other interested jurisdictions that will aid in the development of the AM. The IAIS aims to be in a position by the end of the five-year monitoring period to assess "whether the AM provides comparable (*i.e.*, substantially the same (in the sense of the ultimate goal)), outcomes to the ICS." If so assessed, the AM will be considered an "outcome-equivalent" approach for implementation of ICS as a PCR. According to the IAIS, comparable outcomes to the ICS means that the AM "would produce similar, but not necessarily identical, results over time that trigger supervisory action on group capital adequacy grounds."

The IAIS is developing criteria to assess whether the AM provides comparable outcomes to the ICS, starting with a project plan focused on delivery by the end of the monitoring period. To facilitate the comparability assessment, the IAIS will oversee an annual AM data collection process.

COMFRAME AND ICPs

Structure

Each ICP is presented according to the following hierarchy:

- Principle Statements – the highest level in the hierarchy. Sets out the essential elements that must be present in a jurisdiction "in order to protect policyholders, promote the maintenance of fair, safe and stable insurance markets and contribute to financial stability."
- Standards – the next level in the hierarchy. Provides key high-level requirements fundamental to the implementation of the Principle Statement, which should be met in order for a jurisdiction to demonstrate observance with the particular Principle Statement.
- Guidance – the lowest level in the hierarchy. Supports the Principle Statement and/or Standards with examples and other guidance but does not itself provide any requirements.

ComFrame material follows a similar hierarchy, using ComFrame Standards and ComFrame Guidance that build on the relevant ICP Principle Statement in which the ComFrame material is integrated.

In addition to the ComFrame material set forth in the ICP/ComFrame *Introduction and Assessment Methodology* ("*Introduction*"), which lays out the overarching principles and structural elements of the ICPs and ComFrame and the assessment methodology to be used for each, ComFrame is integrated into: ICP 5 (Suitability of Persons); ICP 7 (Corporate Governance); ICP 8 (Risk Management and Internal Controls); ICP 9 (Supervisory Review and Reporting); ICP 10 (Preventive Measures, Corrective Measures and Sanctions); ICP 12 (Exit from the Market and Resolution); ICP 15 (Investments); ICP 16 (Enterprise Risk Management for Solvency Purposes); ICP 23 (Group-wide Supervision); and ICP 25 (Supervisory Cooperation and Coordination).

As the quantitative component of ComFrame, the ICS is presented as a stand-alone document, but once the ICS is implemented as a group-wide PCR for IAIGs, the ICS will be integrated into the rest of ComFrame.[31] In addition, as discussed below, supervisory measures have been added to the ICPs and ComFrame to address potential systemic risks in the insurance sector in accordance with the Holistic Framework approach.

Given the breadth and scope of ComFame and the interrelated ICPs in which it is integrated, and the fact that the recently adopted ICPs and ComFrame are the result of several years of incremental revisions and refinements, this Memorandum focuses on providing a summary of some of the key principles and implementation and assessment objectives, along with a summary chart as an Appendix hereto indicating, at a high level, the topics addressed by ComFrame within the ICP/ComFrame structure.

IAIGs

The group-wide supervisor is responsible for the identification of IAIGs, in cooperation with other involved supervisors, after considering whether a group meets both of the following criteria:

- Internationally active:
  - Premiums are written in three or more jurisdictions; and
  - Gross written premiums outside of the home jurisdiction are at least 10% of the group's total gross written premiums; and
- Size (based on a three-year rolling average):
  - Total assets are at least USD 50 billion; or
  - Total gross written premiums are at least USD 10 billion.

In limited circumstances, the group-wide supervisor has discretion to determine that a group is not an IAIG even if it meets the IAIG criteria or that a group is an IAIG even if it does not meet the criteria.[32] The group-wide supervisor identifies the "*Head of the IAIG*" as "the legal entity which controls all of the insurance legal entities within the group and non-insurance legal entities which pose risk to the insurance operations." Considerations involved in determining the Head of the IAIG and which supervisor will be the group-wide supervisor are provided in ComFrame 23 (Group-wide Supervision) and ComFrame 25 (Supervisory Cooperation and Coordination), respectively.

According to the IAIS' *Explanatory Note on ComFrame*, group-wide supervisors commit to disclose publicly the identification of IAIGs at the earliest possible opportunity (the IAIS notes this may require legislative changes or regulatory action). From early 2020, the IAIS expects to compile a public register of IAIGs that have been publicly disclosed by group-wide supervisors, which will be accompanied by a comparison of the number of publicly disclosed IAIGs with the total number of IAIGs that have been identified by group-wide supervisors based on meeting the IAIG criteria or the exercise of supervisory discretion. The public register will be regularly updated.

Proportionality

The ICPs establish the minimum requirements for effective insurance supervision and are expected to be implemented and applied in a proportionate manner. According to the proportionality principle set forth in the ICPs and ComFrame, and consistent with the "outcomes-focused" nature of the IAIS material, supervisors may tailor their implementation of supervisory requirements to achieve the outcomes stipulated in the Principle Statements and Standards. Thus, according to the *Introduction*, the ICPs and ComFrame do not favor any particular governance model (*i.e.*, more centralized or more decentralized) and are intended to apply to all governance models.

According to the *Introduction*, the implementation of the Principle Statements and Standards relevant to group-wide supervision may vary across jurisdictions depending on the supervisory powers and structure within a jurisdiction. The *Introduction* cites as an example the distinction between “direct and indirect approaches” to group-wide supervision. Under the direct approach, the supervisor has the necessary powers over the parent and other legal entities in the insurance group and has the authority to impose relevant supervisory measures directly on such legal entities, including non-regulated legal entities. Under the indirect approach, which is similar to the state-based insurance regulatory framework in the United States, supervisory powers focus on the insurance legal entities and supervisory measures are applied to those insurance legal entities to address the group-wide risks posed by other entities within the group, including non-regulated legal entities. According to the IAIS, under either approach the supervisor must be able to deliver effective group-wide supervision, “including that all relevant group-wide risks impacting the insurance entities are addressed appropriately.”

With respect to group-wide supervision of IAIGs under ComFrame, the group-wide supervisor takes responsibility for the supervision of the IAIG as a whole on a group-wide basis. Other involved supervisors are responsible for the supervision of the IAIG’s individual insurance legal entities in their respective jurisdictions and are required to take into account the effect of their supervisory actions on the rest of the IAIG. Although ComFrame, like the ICPs, purports to be neutral as to direct or indirect approaches to group-wide supervision so long as the intended outcomes of the group-wide supervision are achieved, ComFrame does require a direct approach for certain powers as indicated in specific ComFrame Standards (*e.g.*, ICP 9 (Supervisory Review and Reporting) requires the group-wide supervisor to conduct on-site inspections at the level of the Head of the IAIG, and ICP 10 (Preventive Measures, Corrective Measures and Sanctions) requires the group-wide supervisor to apply supervisory measures directly to the Head of the IAIG).

Implementation and Assessment

According to the *Introduction*, current supervisory practices already align with ComFrame in a number of areas, *e.g.*, supervisory colleges are in place for insurance groups meeting the IAIG criteria. However, the IAIS believes member jurisdictions will likely need time to implement ComFrame, including through the enactment of appropriate legislation or regulations. The IAIS will initially focus on supporting members’ efforts in the implementation of ComFrame, concentrating on the identification of IAIGs and supervisory cooperation and coordination. After the initial stage of ComFrame implementation, the IAIS will shift its focus to assessment of the implementation of ComFrame.

Assessments may be conducted in a number of ways, including self-assessments performed by the jurisdiction itself (with the assistance of outside experts and/or followed by peer review and analysis), reviews conducted by third parties, or reviews in the context of the Financial Sector Assessment Program

(FSAP) conducted by the International Monetary Fund and World Bank. Assessments may be conducted on a system-wide jurisdictional basis or focus on specific areas. Standards are generally assessed using five categories: Observed; Largely Observed; Partly Observed; Not Observed; and Not Applicable.

HOLISTIC FRAMEWORK

In recognition that systemic risk may arise not only from the distress or disorderly failure of individual insurers but also from the collective exposures of insurers at a sector-wide level, the Holistic Framework adopted by the IAIS sets forth an integrated set of key elements aimed at assessing and mitigating both entity-level and sector-wide potential sources of systemic risk. Although the FSB and IAIS have suspended entity-level G-SII designations, many elements of the IAIS' G-SII Policy Measures have been incorporated into ICP and ComFrame material and will apply to a much larger set of insurers than the nine G-SIIs designated in the past.[33]

The key elements of the Holistic Framework are:

- an enhanced set of supervisory policy measures for macroprudential purposes designed to help prevent insurance sector vulnerabilities and exposures from developing into systemic risk, including supervisory powers of intervention for responding when a potential systemic risk is detected;
- a global monitoring exercise designed to assess global insurance market trends and detect the possible build-up of systemic risk, including at an individual insurer and sector-wide level; and
- an implementation assessment, whereby the IAIS will assess the consistent implementation of enhanced supervisory policy measures and powers of intervention.

A. SOURCES OF RISK

According to the Holistic Framework, systemic risk may stem from either an individual financial institution or a group of institutions. Systemic risk arising from individual financial institutions is related to the concept of systemically important financial institutions (SIFIs), whose distress or failure, because of the size, complexity, lack of substitutability and interconnectedness, could cause or amplify significant disruption to the wider financial system and real economy. Systemic risk stemming from a group of institutions focuses on collective actions or distress of multiple institutions that operate in the same markets or are active in the same financial instruments, and thus are jointly exposed to certain risks. Consistent with prior G-SII assessment and Holistic Framework releases and proposals, the Holistic Framework identifies several areas of systemic risk as "key exposures" and "transmission channels" in the insurance sector, which the IAIS intends to assess using a holistic approach that takes into account both the time-varying nature and the cross-sectoral aspects of systemic risk.

Key Potential Systemic Exposures

The Holistic Framework identifies the following key exposures in the insurance sector that may lead to systemic impacts:

- *Liquidity risk*, defined as "the risk that an insurer is unable to realize its investments and other assets in a timely manner in order to meet its financial obligations, including collateral needs, as they fall due." The Holistic Framework indicates that liquidity risk vulnerability may be increased through securities lending, derivatives, or the backing of liquid liabilities with illiquid assets.
- *Interconnectedness*, which refers to interlinkages with other parts of the financial system and the real economy. The IAIS identifies two types of interconnectedness exposures:
    - *Macroeconomic exposure*, which is exposure of an insurer or the insurance sector more broadly to macroeconomic risk factors, resulting in its or their financial position being highly correlated with the broader financial markets and real economy and with each other; and
    - *Counterparty exposure*, which is mutual exposure of an individual insurer to counterparties in the broader financial system and real economy, leading to both parties being vulnerable to distress or failure of the other.
- *Limited substitutability*, which refers to the difficulty or inability of continuing the supply of insurance coverage or products to other financial market participants or the financial system after a failure or distress of an individual insurer, but may also apply to groups of insurers that perform a specialized function. (According to the Holistic Framework, competition is high in most insurance business lines and therefore limited substitutability is not likely to become a global systemic concern.)[34]

Transmission channels

The IAIS notes, consistent with past consultations and G-SII assessment methodologies, that exposures within the insurance sector are transmitted or propagated to other market participants or the real economy, and thus have a wider systemic impact on the financial system, through so-called "transmission channels." The IAIS has identified three main transmission channels: (1) asset liquidation; (2) exposure channel; and (3) critical functions. Potential systemic risk may propagate simultaneously through one or more of these channels.

- *Asset liquidation* refers to "the sudden sale of assets on a large scale, by a large insurer or a sufficiently large number of smaller insurers, which could trigger a decrease in asset prices and significantly disrupt trading or funding in key financial markets or cause significant losses or funding problems for other firms with similar holdings."
- *Exposure channel* includes two elements, similar to the macroeconomic/counterparty division with respect to systemic exposures: (1) indirect exposure from macroeconomic exposures due to institutions being exposed to the same or similar asset classes or because their exposures are highly correlated with the financial market; and (2) direct exposure through direct interlinkages between institutions.
- *Critical functions* refers to the systemic impact the interruption of services by an individual insurer may have, where the insurer provides services that are important for the functioning of the financial sector or real economy and there are few, if any, readily available substitutes.

B. SUPERVISORY MATERIAL

The IAIS performed a gap analysis of the existing IAIS supervisory material to determine what additional measures could help mitigate potential systemic risk or provide the necessary foundation for the Holistic Framework. Given the IAIS' move away from the previous binary approach exemplified in the G-SII Policy Measures and G-SII Assessment Methodology and focus on a more proportionate application of an enhanced set of policy measures to a broader portion of the insurance sector, Holistic Framework material has been integrated into the ICPs and ComFrame, although the exact scope of application varies. For example, some Holistic Framework material is contained in the ICPs and thus applicable to all insurance legal entities and groups, including IAIGs; other material is contained in ComFrame and thus only applicable to IAIGs; and some ICP or ComFrame Standards (or parts thereof) indicate that the supervisor is required to apply the Standard to IAIGs and/or other insurers, as applicable, only "as necessary," based on the nature, scale and complexity of the insurer's activities that may lead to increased systemic risk exposure.[35] According to the Holistic Framework, this approach reflects the view that "the criteria for being an IAIG (*i.e.*, size and international activity) may work as a risk amplifier but do not necessarily correspond to whether an insurer is engaged in potential systemic activities or is exposed to certain systemic risks."

The enhanced and additional supervisory policy measures to address systemic risk under the Holistic Framework are contained in certain ICP and ComFrame Standards and Guidance, based on the following thematic areas:

- On-going supervisory policy measures, including:
  - Macroprudential supervision;
  - Requirements on insurers; and
  - Crisis management and planning; and
- Powers of intervention for supervisors.

Macroprudential supervision

ICP 9 (Supervisory Review and Reporting) and ComFrame material integrated therein has been revised to include assessments of not only the risks to which insurers are exposed but also the risks which insurers may pose to policyholders, the insurance sector and financial stability more broadly.

ICP 24 (Macroprudential Supervision), as revised, requires that the "supervisor identifies, monitors and analyzes market and financial developments and other environmental factors that may impact insurers and the insurance sector, uses this information to identify vulnerabilities and address, where necessary, the build-up and transmission of systemic risk at an individual insurer and at the sector-wide level." ICP 24 requires that macroprudential analysis be both quantitative and qualitative, and that it consider both historical trends and the current risk environment and both inward and outward risks. ICP 24 indicates that the supervisor should have in place an appropriate form of stress testing for application to the insurance sector as a whole or to a significant sub-group of insurers.

In order to support supervisors in the implementation of ICP 24, the IAIS plans to develop an Application Paper on Macroprudential Supervision, scheduled for adoption in 2021.

Insurer requirements

The insurer requirements embodied in the ICPs and ComFrame material to address potential systemic risk are targeted at mitigating the insurance risk exposures described above, *i.e*., liquidity risk, counterparty exposure and macroeconomic exposure.

The IAIS has enhanced the enterprise risk management ("*ERM*") requirements in ICP 16 (Enterprise Risk Management for Solvency Purposes) and the related ComFrame material (which include requirements relating to risk identification and measurement, risk appetite statements, asset-liability management, investments, underwriting policies and liquidity risk management), to explicitly target liquidity risk, macroeconomic exposure and counterparty exposure. These requirements are expected to be applied to IAIGs, and to be extended to other insurers "as necessary."

The ERM framework in ICP 16 has been revised to address liquidity risk and to contain strategies, policies and processes to maintain adequate liquidity to meet the insurer's liabilities as they fall due in normal and stressed conditions, including assessment of the insurer's resilience against liquidity stresses, which is recommended to be conducted through stress testing or scenario analyses; maintenance of a portfolio of unencumbered highly liquid assets; development of a contingency funding plan; and submission of a liquidity risk management report to the supervisor.

On November 19, 2019, the IAIS issued an Application Paper on Liquidity Risk Management for pubic consultation providing additional guidance for supervisors to implement ICP 16 and related ComFrame requirements on liquidity risk management and planning, with adoption scheduled for 2020. The Application Paper provides detailed guidance on the following liquidity risk management requirements for insurers, along with requirements for supervisory review of the same:

- *Governance*. Requirements for a proper liquidity risk management governance framework, including production of risk appetite statements, that supports the identification, assessment, management, reporting and planning of risk-mitigating decision making.
- *Liquidity Stress Testing*. Requirements for liquidity stress testing, including a range of severe but plausible scenarios covering short-term and protracted macroeconomic, sector-wide, and idiosyncratic events that appropriately reflect the distinctive features of its business. Liquidity risk drivers are to include: exposure to insurable events; policyholder behavior; contingent or off-balance sheet exposures; the impact of a deterioration in the insurer's credit rating; the ability to transfer liquidity across entities, countries and portfolios; foreign exchange convertibility and access to foreign exchange markets; the reduction in secured and unsecured wholesale funding; and the correlation and concentration of funding sources.

- *Liquidity Portfolio*. Where stress scenarios reveal stressed cash outflows that exceed stressed cash inflows, the insurer should hold liquid assets of sufficient value to cover shortfalls and ensure that it can meet its liabilities as they fall due. Such assets are referred to as the "*Liquidity Portfolio*." The Application Paper proposes the assets eligible for inclusion in the Liquidity Portfolio, along with the bucketing of such assets into primary, secondary and tertiary liquidity buckets, and related requirements (and haircuts) addressing diversification, convertibility-to-cash, and fungibility.
- *Contingency Funding Plan*. Requirements to prepare contingency funding plans, describing the actions that the insurer would take to ensure sufficient liquidity sources, including collateral needs under stress, and strategies, policies and procedures for addressing liquidity shortfalls in an emergency. The Application Paper indicates that insurers may integrate contingency funding plans into their recovery planning.
- *Liquidity Risk Management Report*. Requirements to produce liquidity risk management reports to relevant supervisors, including risk appetite statements, established liquidity risk limits, liquidity risk management strategies and policies, analysis of the Liquidity Portfolio, potential vulnerabilities, and results of liquidity stress testing.

In addition, the IAIS added an additional Standard in ICP 20 (Public Disclosure) to cover a requirement for insurers to publicly disclose quantitative and qualitative information on liquidity risk.

ICP 16 has also been revised to address counterparty exposure and macroeconomic exposure for IAIGs and other insurers "as necessary," requiring a counterparty risk appetite statement, analysis of stress events on material counterparty exposures through scenario analysis or stress testing, and stress testing to assess the resilience of an insurer's total balance sheet against macroeconomic stresses.

Crisis management and planning

The ICPs and related ComFrame material now incorporate resolution requirements from the FSB's *Key Attributes for Effective Resolution Regimes for Financial Institutions* that were applicable to designated G-SIIs. Accordingly, ICP 12 (Exit from the Market and Resolution) and ComFrame material integrated therein set forth requirements on the resolution framework for insurers, resolution powers, resolution planning and recovery planning. Under ICP 12, resolution plans (plans identifying options for resolving all or parts of an insurer to maximize the likelihood of an orderly resolution) and recovery plans (plans identifying options to restore the financial position and viability of an insurer should it come under severe stress) are required for IAIGs "as necessary," taking into account "the activities, lines of business and number of jurisdictions in which the insurer operates, the complexity of the group structure, and the potential impact of failure of the insurer on financial stability." National regulators will therefore have some discretion with respect to requiring IAIGs under their supervision to produce resolution plans and recovery plans.

The IAIS is developing an Application Paper on Resolution Powers and Planning for further guidance, with adoption scheduled for 2021. The IAIS issued a draft Application Paper on Recovery Planning in November 2018.

Further, ICP 25 (Supervisory Cooperation and Coordination) and ComFrame material integrated therein contain a requirement for relevant supervisors to have in place crisis management groups for IAIGs with the objective of enhancing preparedness for, and facilitating the recovery and resolution of, an IAIG.

Powers of intervention

In order to help prevent insurance sector vulnerabilities and exposures from developing into systemic risk, ICP 10 (Preventive Measures, Corrective Measures and Sanctions) requires that supervisors should be able to apply preventive or corrective measures to either prevent a breach of regulatory requirements or respond to a breach of regulatory requirements, including to address threats to financial stability.

C. GLOBAL MONITORING EXERCISE

The IAIS has stated that it will undertake an annual global monitoring exercise to assess insurance market trends and developments, and determine any potential build-up of systemic risk in the global insurance sector. The global monitoring exercise will include an assessment of potential systemic risk arising from sector-wide trends and the possible concentration of systemic risks at an individual insurer level (using an updated assessment methodology modeled on the most recent IAIS G-SII Assessment Methodology).

The global monitoring exercise will include a collective discussion by the IAIS of the assessment of potential systemic risk in the global insurance sector. The IAIS intends to share the outcomes of the global monitoring exercise each year with participating insurers, IAIS members, the FSB and the general public.

The global monitoring exercise will focus on the 10 categories identified in the chart below, which indicates which categories will apply to individual insurer monitoring ("*IIM*"), sector-wide monitoring ("*SWM*"), or both.

Category	IMM	SWM
Size	X	X
Global activity	X	
Interconnectedness - Counterparty exposure	X	X
Interconnectedness - Macroeconomic exposure	X	X
Asset liquidation	X	X
Substitutability	X	X
Underwriting & Solvency		X
Policyholder behavior		X
Emerging risks		X
Economic environment		X

Individual insurer monitoring

The IIM will be based on an updated IAIS methodology and will first be applied during the 2020 global monitoring exercise. The IIM will be facilitated through individual insurer and insurer pool assessment of systemic risk, including individual absolute assessments (scores of individual insurers calculated based on an absolute indicator-based methodology) and individual relative assessments (scores of individual insurers calculated based on a relative indicator-based methodology).

According to the Holistic Framework, "the IIM assessment is no longer focused on identifying prospective G-SIIs, but rather aims to support a comprehensive assessment by the IAIS on the potential build-up of systemic risk in the insurance sector as a whole by looking at potential systemic risk from activities or exposures concentrated in individual insurers." The IIM assessment is based on data collected from five categories that include 14 indicators; despite the stated move away from entity designations, the assessment methodology in the Holistic Framework's IIM assessment is substantially similar to the G-SII Assessment Methodology previously produced by the IAIS (*e.g.*, compared to the 2016 G-SII Assessment Methodology, three indicators were dropped and five indicators were refined). The chart below sets forth the applicable categories, indicators and weights used to produce individual insurer scores.

Category	Subcategory	Indicator	Weight
Size		Total assets	2.5%
		Total revenues	2.5%
Global Activity		Revenues outside of home country	2.5%
		Number of countries	2.5%
Interconnectedness	Counterparty exposure	Intra-financial assets	9.4%
		Intra-financial liabilities	9.4%
		Derivatives	9.4%
	Macroeconomic exposure	Derivatives trading (CDS or similar derivatives instrument protection sold)	9.4%*
		Financial guarantees	9.4%*
		Minimum guarantees on variable products	9.4%
Asset Liquidation		Short-term funding	9.4%
		Level 3 assets	9.4%
		Liability liquidity	9.4%
Substitutability		Premiums for specific business lines	5.0%

* Uses an absolute reference value

Sector-wide monitoring

The SWM will include an annual data collection exercise that contains information from IAIS members based on aggregated data from insurance legal entities operating in IAIS member jurisdictions and supervisors' assessments of macroprudential risks, as well as additional data collected by the IAIS based on public sources.

D. IMPLEMENTATION ASSESSMENT / SUSPENSION OF G-SII IDENTIFICATION

The IAIS' implementation assessment for the Holistic Framework builds on existing methodologies for assessing implementation of the ICPs and ComFrame. Assessments will proceed in phases, beginning with a baseline assessment in 2020 and moving towards more intensive jurisdictional assessments in 2021, which will include targeted in-depth verification of supervisory practices. The IAIS intends to share the outcomes of the Holistic Framework implementation assessments with the FSB and the general public.

In light of the adopted Holistic Framework, the FSB, in consultation with the IAIS and national authorities, has decided to suspend G-SII identification as from the beginning of 2020. In November 2022, the FSB will, based on the initial years of implementation of the Holistic Framework, review the need to either discontinue or re-establish an annual identification of G-SIIs by the FSB.

* * *

ENDNOTES

[1] See, IAIS, *Media Release – IAIS adopts first global frameworks for supervision of internationally active insurance groups and mitigation of systemic risk in the insurance sector*, November 14, 2019, available at: https://www.iaisweb.org/page/news/press-releases//file/87183/media-release-iais-adopts-first-global-frameworks-for-supervision-of-internationally-active-insurance-groups-and-mitigation-of-systemic-risk-in-the-insurance-sector.

[2] Subject to limited exceptions, an IAIG is any insurance group that meets both of the following criteria: (1) premiums are written in three or more jurisdictions and gross written premiums outside of the home jurisdiction are at least 10% of the group's total gross written premiums; and (2) based on a rolling three-year average, total assets are at least $50 billion or total gross written premiums are at least $10 billion. In accordance with standards and guidance set forth in ComFrame, the relevant group-wide supervisor, in cooperation with other involved supervisors, is responsible for designating, and is expected to publicly disclose, any IAIGs under its jurisdiction. The IAIS indicated in July 2018 that it expects approximately 50 IAIGs will be identified.

[3] The IAIS published six documents in connection with its adoption of ICS 2.0: (1) *Explanatory Note on the ICS and Comparability Assessment*; (2) *Level 1 Document for ICS Version 2.0 for the monitoring period*; (3) *High Level Messages – ICS Version 2.0 for the monitoring period and Comparability Assessment*; (4) *Technical Note on ICS Version 2.0 for the monitoring period*; (5) *Operationalisation of the Monitoring Period*; and (6) *Work Plan and Timetable 2020-24*, all of which are available at: https://www.iaisweb.org/page/supervisory-material/insurance-capital-standard.

[4] The IAIS published three documents in connection with its adoption of ComFrame: (1) *IAIS ICPs and ComFrame adopted in November 2019*; (2) *Explanatory Note on ComFrame*; and (3) *ComFrame Frequently Asked Questions*, all of which are available at: https://www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe.

[5] The IAIS published three documents in connection with its adoption of the Holistic Framework: (1) *Explanatory Note on Holistic Framework for systemic risk*; (2) *Holistic Framework for Systemic Risk*; and (3) *Global Monitoring Exercise*, all of which are available at: https://www.iaisweb.org/page/supervisory-material/financial-stability.

[6] Between 2013 and 2016, the FSB, in consultation with the IAIS and national authorities, had published an annual list of identified G-SIIs. In each of those years, nine G-SIIs were identified (with one exception, the same groups were designated each year). In light of IAIS development and adoption of the Holistic Framework, the FSB has decided to continue suspending the annual identification of G-SIIs. The FSB has stated that it will review in November 2022 the need to either discontinue or re-establish an annual identification of G-SIIs based on the initial implementation of the Holistic Framework. See, FSB, *FSB welcomes insurance holistic framework*. November 14, 2019, available at: https://www.fsb.org/2019/11/fsb-welcomes-insurance-holistic-framework/.

[7] IAIS, *Draft Application on Liquidity Risk Management for Public Consultation*, November 19, 2019, available at: https://www.iaisweb.org/page/consultations/current-consultations/draft-application-paper-on-liquidity-risk-management//file/87253/draft-application-paper-on-liquidity-risk-management-for-public-consultation.

[8] IAIS, *Draft Application Paper on Recovery Planning*, November 12, 2018, available at: https://www.iaisweb.org/page/consultations/closed-consultations/2018/application-paper-on-recovery-planning .

[9] The IAIS Glossary was also revised in November 2019, except for terms related to ICPs 14 and 17. Those terms will be revised together with the revision of ICPs 14 and 17. The IAIS Glossary is available at: https://www.iaisweb.org/page/supervisory-material/glossary.

ENDNOTES (CONTINUED)

10 Information on current developments of the GCC is available at: https://content.naic.org/cmte_e_grp_capital_wg.htm. The NAIC noted at its Fall 2019 National Meeting that a "jurisdictionally agnostic" aggregation method, and not necessarily the GCC itself, will be the standard ultimately submitted to the ICS for "comparable outcome" purposes.

11 For additional information, see our memorandum to clients. "*Federal Reserve Proposes Regulatory Capital Framework for Insurance Depository Institution Holding Companies*" (October 10, 2019), available at: https://www.sullcrom.com/files/upload/SC-Publication-Federal-Reserve-Proposes-Regulatory-Capital-Framework-for-Supervised-Insurance-Groups.pdf.

12 On a related note, according to a "Policy Statement" issued by the U.S. Treasury, the United States expects the GCC to satisfy the group capital assessment conditions set forth in the "Covered Agreement" signed between the United States and the EU in September 2017, such that the GCC, if completed and implemented within the five-year period specified therein, would effectively be recognized as "equivalent" to the Solvency II's group capital assessment for purposes of the group supervision measures of the Covered Agreement. For additional information, see our memorandum to clients. "*U.S. and EU Sign Covered Agreement*" (September 27, 2017), available at: https://www.sullcrom.com/us-and-eu-sign-covered-agreement-9-27-17.

13 If it is so assessed, the AM "will be considered an outcome-equivalent approach for implementation of ICS as a PCR."

14 See, FIO, *Readout on the International Association of Insurance Supervisors Annual Meeting*, November 14, 2019, available at: https://home.treasury.gov/news/press-releases/sm830. In addition, in November 2019, a group of 30 senators signed a bipartisan letter to the U.S. Treasury Secretary raising concerns about the IAIS adoption of ICS, which is available at: https://www.scott.senate.gov/download/11/12/19-letter-to-sec-mnuchin.

15 See *NAIC's Interpretive Guidance on ICS Comparability Assessment Framework*, available at: https://content.naic.org/sites/default/files/inline-files/ICS%20Interpretive%20Guidance%20on%20Comparability%20Assessment%20Framework.pdf.

16 For additional information, see our memorandum to clients. "*IAIS—Holistic Framework for Systemic Risk in the Insurance Sector*" (November 27, 2018), available at: https://www.sullcrom.com/files/upload/SC-Publication-IAIS-Proposes-Holistic-Framework-to-Assess-Systemic-Risk-FSB-to-Forgo-Identification-of-GSIIs-in-2018.pdf.

17 FSOC, *Final Interpretive Guidance, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (Dec. 4, 2019), available at: https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf.

18 As the ICS is designed as a minimum standard, national authorities may elect to set a PCR that is higher than the ICS PCR.

19 IAIS, *Instructions for the April 2019 Quantitative Data Collection Exercise of the Field Testing Project (the "Technical Specifications")*, available at: https://www.iaisweb.org/page/supervisory-material/insurance-capital-standard/file/82711/public-2019-iais-field-testing-technical-specifications.

20 Based on prior ICS consultations, each ICS rating category will map to specified rating categories used by Standard & Poor's, Moody's, Fitch and other named credit rating agencies.

21 Prior field testing technical specifications provided guidance on how to generate a balance sheet on an aggregated basis for insurance groups that do not report consolidated or group level financial statements; additional guidance may be provided in Level 2 or Level 3 documents.

[22] The Level 1 document does not provide details on how the separation of insurance vs. non-insurance entities, and their subsequent consolidation, is to be conducted. The ICS 2.0 public consultation document, issued in July 2018, states that the insurance component of the ICS capital requirement is to be calculated on a consolidated basis after excluding investments or exposures to non-insurance financial entities subject to other financial sector capital requirements, and that the overall ICS capital requirement is the aggregation of the ICS insurance component and ICS components from other financial sectors. According to the Technical Note, capital requirements for non-insurance entities will include proportional sectoral requirements for entities reporting on the equity method; an equity risk charge for market value / GAAP value investments; and an equity risk charge for non-financial entities.

[23] Prior field testing technical specifications provided specific guidance for U.S. mutual insurers whose financial statements are only prepared in accordance with SAP, including various adjustments required to approximate a "quasi-consolidated" group-level GAAP balance sheet; additional guidance may be provided in Level 2 or Level 3 documents.

[24] Where future cash flows associated with insurance obligations can be reliably replicated using financial instruments for which a market value is observable, the value of insurance liabilities associated with the future cash flows is determined on the basis of the market value of the financial instruments. Additional conditions under this approach will be specified in the Level 2 document.

[25] A contract boundary corresponds to the time and projection horizon in which all of the cash in- and out-flows required to settle obligations under the insurance contract are determined for purposes of current estimate calculations. Note that this and other terms used in the ICS (*e.g.*, current estimates, margin over current estimates, capital requirements, capital resources, *etc*.) correspond roughly, but not completely given the differences in approach, to comparable terms used in the U.S. insurance regulatory context (*e.g.*, reserves, margin over reserves, risk-based capital, total adjusted capital, *etc*.).

[26] More specifically, the risk-free yield curve is determined based on a three-segment approach comprising: (1) market information from government bonds or swaps, including a credit risk correction, where necessary; (2) extrapolation between the first and third segments; and (3) a stable currency specific long-term forward rate (LTFR) to which a spread is added in order to represent the expected spread that may be earned from long-term reinvestments. The adjustment to the risk-free yield curve is determined using the three-bucket approach, which classifies liabilities into a General Bucket, Middle Bucket and Top Bucket, depending on the nature of the liabilities and the assets backing the liabilities; a different yield curve adjustment is determined for each bucket. Criteria for each bucket have been provided in prior field testing specifications, according to which: the Top Bucket relies on the insurance group's asset structure and specific spreads (*i.e.*, the bucket is applied only to those liabilities meeting the most restrictive criteria so as to ensure the IAIG will be able to hold its own assets to maturity and earn the spreads being used to discount insurance liabilities); the General Bucket is a catch-all bucket for insurance liabilities that do not meet the criteria in the other buckets and is calculated on a market-wide basis; and the Middle Bucket represents a balance between the other buckets, mixing market and group-specific inputs by using market spreads weighted on the basis of the IAIG's own asset structure. Additional guidance may be provided in Level 2 or Level 3 documents.

ENDNOTES (CONTINUED)

27 The IAIS has explored two approaches to MOCE in prior field testing and public consultations: (1) a "cost of capital" approach intended to include a margin in the valuation of insurance liabilities in order to achieve a risk-adjusted valuation of such liabilities in an amount sufficient to allow the transfer of the insurance obligations to a willing third party or to allow fulfillment of the obligations internally, and where the "cost of capital" MOCE would not be deducted from ICS capital requirements; and (2) a "prudence" approach intended to be a simple and comparable way to calculate a consistent margin to ensure policyholder protection, and where the "prudence" MOCE would be fully deducted from ICS capital requirements. The adopted ICS 2.0 reflects the cost of capital approach, which has been criticized by multiple stakeholders for, among other issues, double counting risks by reducing available capital for risks already captured in ICS capital requirements (*i.e.*, U.S. stakeholders have argued that margins over the current estimates should count as loss absorbing available capital).

28 U.S. stakeholders have generally argued that structural subordination is sufficient to guarantee that policyholders will be paid first in a winding-up because under the U.S. insurance regulatory framework capital cannot in most cases be removed from an insurance company to repay holding company debt holders without regulatory approval.

29 According to the Technical Note, a provision for extraordinary calls has been introduced in the criteria for Tier 1 Limited financial instruments to allow for calls in the first five years after issuance of an instrument in cases of regulatory or tax events, provided the financial instrument is replaced with another of similar or better quality. In addition, the criteria for Tier 2 Paid-Up financial instruments now recognize financial instruments that are callable within the first five years from issuance, provided that: (1) the call is at the option of the issuer only, (2) the call is subject to supervisory approval, and (3) the called instrument must be replaced in full before or at issuance with the same or higher quality instruments (for structurally subordinated financial instruments, the supervisory approval requirement may be fulfilled through the ability of the supervisor to limit, defer or disallow the redemption). Finally, the Technical Note provides that, although the IAIS is retaining the requirement that Tier 2 Paid-Up financial instruments may not allow acceleration clauses that can be triggered while the insurer is a going concern, national discretion will now be permitted in respect of recognizing acceleration clauses as Tier 2 Paid-Up capital, subject to certain conditions.

30 The Technical Note indicates that a new distinction between mutual and non-mutual IAIGs in respect of principal loss absorbency mechanisms ("*PLAM*") has been introduced. PLAM provides a means for financial instruments to absorb losses on a going-concern basis through contractually based reductions in their principal amount and cancellation of distributions. According to the Technical Note, the 10% limit for Tier 1 Limited financial instruments for non-mutual IAIGs is maintained for Tier 1 Limited financial instruments that do not have a PLAM, but an additional 5% allowance is granted to those Tier 1 Limited financial instruments that do have a PLAM, whereas for mutual IAIGs a PLAM is not required as part of Tier 1 Limited capital resources and the Tier 1 Limit is maintained at 30% of the ICS capital requirement.

31 ComFrame does, however, currently include Standards according to which the group-wide supervisor requires the head of the IAIG to report the reference ICS and, at the option of the group-wide supervisor, any additional reporting related to the ICS; and requires members of the supervisory college to discuss and assess a summary of the reference ICS prepared by the group-wide supervisor, as well as a summary of any additional reporting.

32 ComFrame 23 (Group-wide supervision) sets forth examples, including, among others, where the group's international activity or size have increased/decreased due to temporary or transitory effects or where expected changes in meeting the IAIG criteria are expected due to acquisitions/disposals.

ENDNOTES (CONTINUED)

[33] According to the Holistic Framework, "the IAIS revised a number of ICPs and ComFrame material integrated therein by enhancing or adding supervisory policy measures specifically designed to assess and mitigate potential systemic risk building up in the insurance sector. The measures are expected to be applied to a broader portion of the insurance sector, in a proportionate manner."

[34] The Holistic Framework notes that size and global activity are not identified as separate sources of risk but that "these factors are not irrelevant in the determination of systemic risk in the insurance sector and may work as risk amplifiers."

[35] As an example, enterprise risk management requirements relating to liquidity risk are required for IAIGs, but are required "as necessary only" to other insurers, whereas public disclosure requirements on liquidity risk are required for all insurers. Likewise, resolution plans are not required at all for non-IAIGs and only required "as necessary" for IAIGs. The Holistic Framework provides a chart indicating the scope of application with respect to Holistic Framework-based ICP and ComFrame material.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
Robert G. DeLaMater	+1-212-558-4788	delamaterr@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Marion Leydier	+1-212-558-7925	leydierm@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Roderick M. Gilman Jr.	+1-212-558-3277	gilmanr@sullcrom.com
Washington, D.C.		
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
London		
Ben Perry	+44-20-7959-8477	perryb@sullcrom.com
Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Tokyo		
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
Garth W. Bray	+852-2826-8691	brayg@sullcrom.com

APPENDIX

Key ComFrame Elements Within the ICP / ComFrame Structure

Each ICP and its corresponding Principle Statement is shown, along with a high level summary of key ComFrame Standards contained within the relevant ICP. Where no ComFrame material is summarized for an ICP below, the ICP contains no ComFrame material.

ICPs and ComFrame Summary
ICP 1 – Objectives, Powers and Responsibilities of the Supervisor **Principle Statement:** Each authority responsible for insurance supervision, its powers and the objectives of insurance supervision are clearly defined
ICP 2 – Supervisor **Principle Statement:** The supervisor is operationally independent, accountable and transparent in the exercise of its responsibilities and powers, and has adequate resources to discharge its responsibilities
ICP 3 – Information Sharing and Confidentiality Requirements **Principle Statement:** The supervisor obtains information from, and shares information with, relevant supervisors and authorities subject to confidentiality, purpose and use requirements
ICP 4 – Licensing **Principle Statement:** A legal entity which intends to engage in insurance activities must be licensed before it can operate within a jurisdiction. The requirements and procedures for licensing must be clear, objective and public, and be consistently applied
ICP 5 – Suitability of Persons **Principle Statement:** The supervisor requires Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer to be and remain suitable to fulfil their respective roles **ComFrame – Some limited ComFrame material included to link competency/suitability determinations to the complexity and international nature of IAIGs**
ICP 6 – Change of Control and Portfolio Transfers **Principle Statement:** The supervisor assesses and decides on proposals: to acquire significant ownership of, or an interest in, an insurer that results in a person (legal or natural), directly or indirectly, alone or with an associate, exercising control over the insurer; and for portfolio transfers
ICP 7 – Corporate Governance **Principle Statement:** The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer's business and adequately recognizes and protects the interests of policyholders **ComFrame – More prescriptive requirements than the ICP in regard to governance and risk management at the Head of the IAIG, including annual reporting to group-wide supervisor on governance strategies, and ad hoc reporting on material changes**
ICP 8 – Risk Management and Internal Controls **Principle Statement:** The supervisor requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit **ComFrame – More prescriptive requirements than the ICP in regard to group-wide risk management and internal controls at the level of the Head of the IAIG, including:** • **Annual review of group-wide risk management system**

ICPs and ComFrame Summary
• **Annual testing and assessments on internal controls** • **Requirements relating to the group-wide risk management function; compliance function; actuarial function; internal audit function; and outsourcing policies and procedures**
ICP 9 – Supervisory Review and Reporting **Principle Statement:** The supervisor uses off-site monitoring and on-site inspections to: examine the business of each insurer; evaluate its financial condition, conduct of business, corporate governance framework and overall risk profile; and assess its compliance with relevant legislation and supervisory requirements. The supervisor obtains the necessary information to conduct effective supervision of insurers and evaluate the insurance market **ComFrame –** • **Requires group-wide supervisor to carry out supervisory reviews with other involved supervisors** • **Group-wide risk assessment to be conducted at least annually, including assessment of group-wide capital adequacy, non-regulated and non-financial entities, results of group-wide stress tests, and macroprudential analysis** • **Head of IAIG required to report reference ICS and any additional ICS reporting** • **Group-wide supervisor to perform on-site inspections at level of Head of IAIG** • **Reporting requirements respecting supervisory colleges**
ICP 10 – Preventive Measures, Corrective Measures and Sanctions **Principle Statement:** The supervisor requires and enforces preventive and corrective measures and imposes sanctions, which are timely, necessary to achieve the objectives of insurance supervision, and based on clear, objective, consistent, and publicly disclosed general criteria **ComFrame –** • **Group-wide supervisor "applies supervisory measures directly to the Head of the IAIG. If the Head of the IAIG is not within the group-wide supervisor's jurisdiction, other involved supervisors apply supervisory measures to assist the group-wide supervisor."** • **Coordination between involved supervisors in relation to preventive/corrective measures** • **Group-wide supervisor requires Head of the IAIG to take preventive measures under certain circumstances, and imposes sanctions directly on Head of the IAIG within the group-wide supervisor's jurisdiction**
ICP 11 – There is no longer an ICP 11 (subsumed under ICP 10)
ICP 12 – Exit from the Market and Resolution **Principle Statement:** Legislation provides requirements for: the voluntary exit of insurers from the market; and the resolution of insurers that are no longer viable or are likely to be no longer viable, and have no reasonable prospect of returning to viability **ComFrame –** • **Resolution of an IAIG seeks to minimize reliance on public funding** • **Resolution plans are in place for IAIGs where group-wide supervisor and/or resolution authority, in consultation with crisis management group, deems necessary** • **Group-wide supervisor and/or resolution authority undertakes resolvability assessments** • **Head of IAIG required to have and maintain group-wide management information systems (MIS) for the purpose of resolution planning** • **Powers supervisor and/or resolution authority may exercise for resolution of IAIGs must include specified items, including (among others) prohibitions on dividends/asset transfers, restructuring or writing down of liabilities, transfer of assets/contracts/reinsurance, stays on withdrawals and creditor actions, establishing a bridge institution, temporary stay on early termination of derivatives, and liquidation**

ICPs and ComFrame Summary
ICP 13 – Reinsurance and Other Forms of Risk Transfer **Principle Statement:** The supervisor requires the insurer to manage effectively its use of reinsurance and other forms of risk transfer. The supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction
ICP 14 – Valuation[1] **Standard:** The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes
ICP 15 – Investments **Principle Statement:** The supervisor establishes regulatory investment requirements for solvency purposes in order for insurers to make appropriate investments taking account of the risks they face **ComFrame – Head of IAIG required to conduct its own due diligence to avoid undue reliance on credit rating agencies, and to consider effect of impediments on transfer of capital and assets on a cross-border basis**
ICP 16 – Enterprise Risk Management for Solvency Purposes **Principle Statement:** The supervisor requires the insurer to establish within its risk management system an enterprise risk management (ERM) framework for solvency purposes to identify, measure, report and manage the insurer's risks in an ongoing and integrated manner **ComFrame – More prescriptive requirements than the ICP on group-wide ERM framework, including:** • **Head of IAIG required to measure all reasonably foreseeable, quantifiable and relevant material risks using an economic capital model** • **IAIG's risk measurement must include stress and reverse stress testing and scenario analysis** • **Group-wide ERM framework requires independent review at least once every three years** • **Head of IAIG to establish and maintain group-wide investment policy, including counterparty risk appetite statements and criteria for intra-group investments** • **Requires procedures and monitoring practices for use of data for underwriting, pricing, reserving and reinsurance processes** • **Requires group-wide claims management policy, group-wide strategy for reinsurance and other forms of risk transfer, and group-wide actuarial policy** • **Requires liquidity stress testing, maintenance of adequate level of unencumbered highly liquid assets in appropriate locations, contingency funding plans, and at least annual reporting on liquidity risk management** • **Requires group-wide Own Risk and Solvency Assessment ("ORSA") to assess the adequacy of its risk management and current, and likely future, solvency position** • **Requires Head of IAIG to develop recovery plan and maintain group-wide MIS relevant to recovery planning**
ICP 17 – Capital Adequacy **Principle Statement:** The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention
ICP 18 – Intermediaries **Principle Statement:** The supervisor sets and enforces requirements for the conduct of insurance intermediaries, in order that they conduct business in a professional and transparent manner

[1] Note that the current version of ICP 14 contains many elements and concepts reflected in ICS 2.0, including current estimates based on expected present value of future cash flows, discounting of technical provisions, and MOCE. Likewise, ICP 17 (Capital Adequacy) contemplates features reflected in ICS 2.0, *e.g.*, internal models and tiering of qualifying capital.

ICPs and ComFrame Summary
ICP 19 – Conduct of Business **Principle Statement:** The supervisor requires that insurers and intermediaries, in their conduct of insurance business, treat customers fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied
ICP 20 – Public Disclosure **Principle Statement:** The supervisor requires insurers to disclose relevant and comprehensive information on a timely basis in order to give policyholders and market participants a clear view of their business activities, risks, performance and financial position
ICP 21 – Countering Fraud in Insurance **Principle Statement:** The supervisor requires that insurers and intermediaries take effective measures to deter, prevent, detect, report and remedy fraud in insurance
ICP 22 – Anti-Money Laundering and Combating the Financing of Terrorism **Principle Statement:** The supervisor requires insurers and intermediaries to take effective measures to combat money laundering and terrorist financing. The supervisor takes effective measures to combat money laundering and terrorist financing
ICP 23 – Group-wide Supervision **Principle Statement:** The group-wide supervisor, in cooperation and coordination with other involved supervisors, identifies the insurance group and determines the scope of group supervision **ComFrame –** • **Criteria for IAIG determination and Standards on group-wide supervisor discretion when identifying IAIGs** • **Standards and Guidance on identification of Head of IAIG** • **Non-insurance legal entity risks within IAIG group** • **Involvement of other involved supervisors and supervisory college** • **Requirement for group-wide supervisor to obtain information necessary to apply Standards to Head of IAIG concerning all legal entities controlled by Head of IAIG**
ICP 24 – Macroprudential Supervision **Principle Statement:** The supervisor identifies, monitors and analyzes market and financial developments and other environmental factors that may impact insurers and the insurance sector, uses this information to identify vulnerabilities and address, where necessary, the build-up and transmission of systemic risk at the individual insurer and at the sector-wide level
ICP 25 – Supervisory Cooperation and Coordination **Principle Statement:** The supervisor cooperates and coordinates with involved supervisors and relevant authorities to ensure effective supervision of insurers operating on a cross-border basis **ComFrame –** • **Establishment of supervisory college for IAIG which meets at least annually** • **Guidance on determining group-wide supervisor of IAIG** • **Establishment of crisis management group for IAIG**