Insurance & Reinsurance

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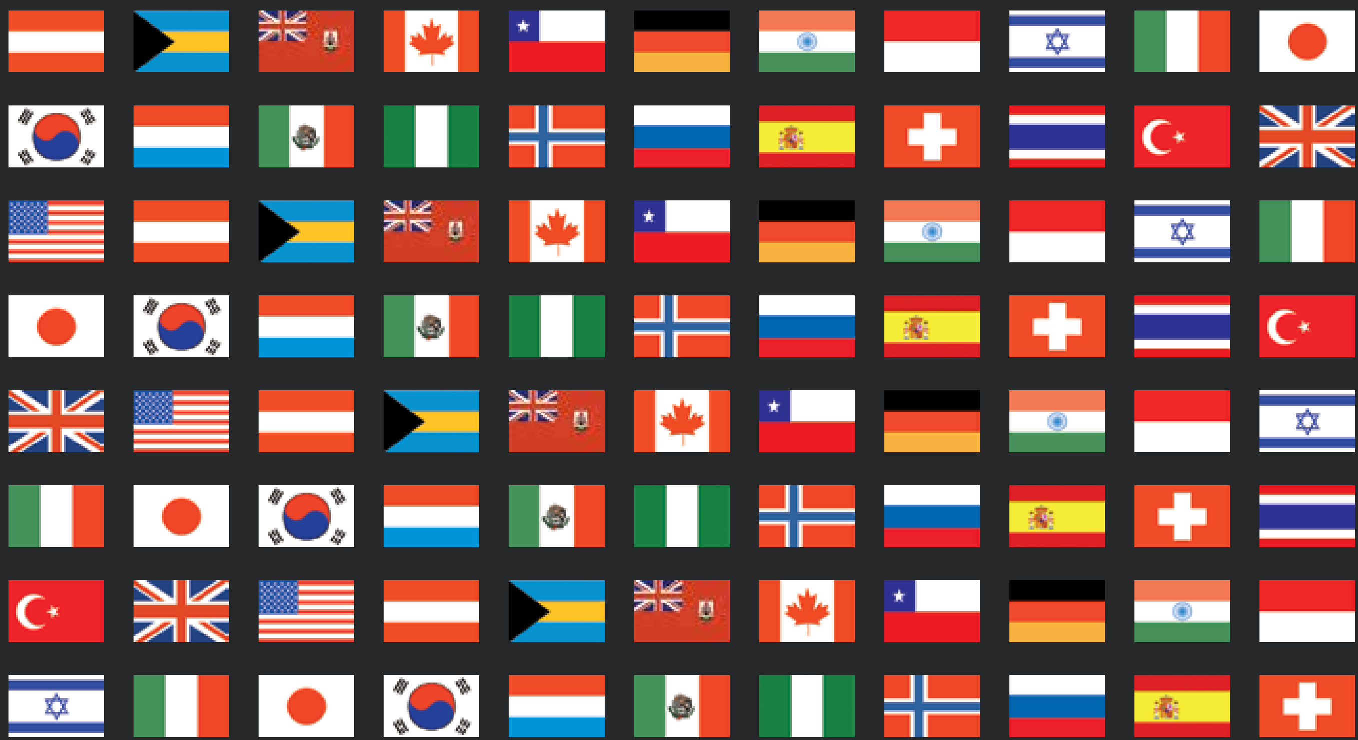
Contributing editors
William D Torchiana, Mark F Rosenberg and Marion Leydier



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GETTING THE DEAL THROUGH

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Sullivan & Cromwell LLP

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Introduction

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Sullivan & Cromwell LLP

The regulatory landscape for insurance companies that conduct operations in multiple jurisdictions is undergoing significant change, largely in response to developments following the financial crisis of 2007–2008. In the US, the individual states and the federal government have begun implementing various regulatory and legislative changes that will fundamentally affect the operations of large international insurance groups, and the insurance industry can expect further significant developments within the next few years from both the states and the federal government in the US, and as a result of various international initiatives currently underway. Likewise, standards and policy measures under development internationally by the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS), once finalised and implemented, will have significant implications on the regulatory framework applied to international insurance groups. As the legal environment is likely to continue to be in a state of flux for several years to come, it will be critical for practitioners who provide corporate and transactional advice to stay abreast of the latest developments with respect to US and international insurance initiatives.

Significant developments at the US state level

Historically, the insurance industry in the Unites States has been regulated almost exclusively by the individual states. Every state has a comprehensive body of statutes, regulations, accounting principles and actuarial guidelines that govern virtually every aspect of an insurance company's operations, including licensing, capital and reserve adequacy, permitted investments, transactions with affiliated companies and reinsurance. At its core, the insurance regulatory framework in the US is designed to protect insurers and their policyholders from risk in other parts of the insurer's holding company group by subjecting individual insurers to stand-alone capital requirements based on statutory accounting principles, and imposing significant capital and asset mobility constraints and other regulatory protections. These laws are generally aimed at insulating state-regulated insurers from contagion by affiliates, whether they are domiciled in the US or in foreign jurisdictions.

Beginning in 2008, US insurance regulators, through the National Association of Insurance Commissioners (NAIC), began reviewing lessons learned from the financial crisis and, specifically, studied the case of American International Group (AIG) and the potential impact of non-insurance operations on insurance companies in the same group. At the heart of the lessons learned from the 2007–2008 financial crisis was the need for insurance regulators to be able to assess the enterprise risk within a holding company system, both nationally and internationally, and its potential impact on insurers within that group.

One result of this reevaluation and broadening focus on the internationalisation of insurance was the adoption of legislation by many states authorising the establishment of supervisory colleges. A supervisory college is a convention comprising the principal insurance regulators of a specific insurance group that meets periodically to facilitate cooperation and exchange of information on a group-wide basis among regulators, as a complement to the supervision of individual entities within a group.

Another new group solvency initiative being implemented at the individual US state level is the own risk and solvency assessment (ORSA), which will require, beginning as early as 2015, large and medium-sized US insurance groups to conduct at least annually an internal assessment of the material and relevant risks associated with the insurer or insurance group's current business plan, and the sufficiency of capital resources to support those risks. The ORSA concept – which is also embedded in the standards proposed by the IAIS – is currently in various stages of implementation in the US.

US states have also made significant progress in the past few years in adopting the latest revisions to the NAIC model insurance holding company act, which provides state insurance regulators with new group-wide supervisory tools, including a new enterprise risk report that insurance holding companies will be required to submit at least annually. The enterprise risk report, to be filed with the lead state commissioner of the holding company system, must identify the material risks within the holding company system that could pose enterprise risk.

Notwithstanding the significant state-based developments in the area of group-wide supervision, the NAIC and state regulators are unlikely to completely jettison the solo entity ring-fencing principle, which has been a cornerstone of policyholder protection in the view of the NAIC and state regulators. At the same time, however, the EU's Solvency II Directive, scheduled to come into effect in 2016, includes mechanisms for consolidated group-level supervision, as well as extensive revisions to the solvency framework and prudential regime applicable to insurance groups based in, or with operations in, the EU. Debate as to the right approach to group-wide supervision of insurers is likely to continue, creating uncertainty for marketplace participants as to the regulatory landscape that will apply to insurance companies operating in multiple jurisdictions.

Significant developments at the US federal level

At the US federal level, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (Dodd-Frank Act) introduced a new era of federal regulation of certain areas of insurance in the US, Inter alia, the Dodd-Frank Act established the Federal Insurance Office (FIO) to monitor the insurance industry and identify gaps in regulation that could contribute to a systemic crisis, and granted the Board of Governors of the Federal Reserve System (Federal Reserve) significant regulatory powers over systemically important insurers and other insurers that are affiliated with an insured depository institution. As a result of the Dodd-Frank Act, the insurance holding companies for which the Federal Reserve is the consolidated supervisor hold approximately one-third of US insurance industry assets, according to recent Congressional testimony by the Federal Reserve.

Federal Insurance Office

While the FIO has no general supervisory or regulatory authority over the business of insurance, it is authorised to coordinate and develop federal policy on prudential aspects of international insurance matters. In particular, the FIO is taking a primary role in representing the US government within the IAIS and plays an important role, as chair of the IAIS Technical Committee, in developing international insurance regulatory standards and initiatives.

The FIO may also recommend to the Financial Stability Oversight Council (FSOC) that it designate an insurer as a systemically important financial institution (SIFI) to be subject to enhanced prudential standards and supervision by the Federal Reserve. To date, the FSOC has designated three US insurers – AIG, MetLife and Prudential Financial – as SIFIs (although MetLife is currently contesting its SIFI designation in court).

In December 2013, the FIO released its 'modernisation' report, which includes 27 recommendations for modernising insurance regulation in the US, most of which relate to 'near-term' state-based reforms respecting capital adequacy and solvency, reserving requirements and captive reinsurers, as well as marketplace regulation. The principal recommendations in the FIO report relating to international insurance include a call for the FIO to participate in supervisory colleges established for US firms operating nationally and internationally (and for non-US firms with large operations in the US), and the establishment of uniform reinsurance collateral requirements based on NAIC reinsurance model laws.

The FIO modernisation report suggests there may be a basis for federal involvement if the states fail to accomplish reforms in the near term. It is expected that state insurance departments, through the NAIC, will continue to support the creation and implementation of more uniform laws across the states in order to prevent such federal intervention and maintain the current state-based system. Many of the report's recommendations were reiterated in the FIO's 2014 annual report, released in September 2014.

Federal Reserve supervision of certain insurance groups

Until the enactment of the Dodd-Frank Act, the Federal Reserve and other federal banking agencies generally only had regulatory authority over insurance groups to the extent an insurance group owned a bank or a savings and loan company, with the parent company qualifying as a bank holding company (BHC) or savings and loan holding company (SLHC). As noted above, pursuant to the Dodd-Frank Act, the FSOC now has the power to designate nonbank financial companies, including insurance groups, as SIFIs, which are then also subject to supervision and examination by the Federal Reserve, and to 'enhanced prudential standards' for which the Federal Reserve is required to establish regulations pursuant to title I of the Dodd-Frank Act. These enhanced prudential standards have yet to be finalised for insurance-owned SIFIs, whereas certain of such standards applicable to non-insurer SIFIs have already been specified in rules promulgated by the Federal Reserve and other federal agencies. The enhanced prudential standards include, or will include, requirements and limitations relating to risk-based capital, leverage, liquidity, stress testing, risk management, resolution planning, early remediation, management interlocks and credit concentration, and may also include additional standards regarding capital, public disclosure, short-term debt limits and other related subjects at the discretion of the Federal Reserve and the FSOC.

Many of the enhanced prudential standards will apply in addition to already-existing state insurance statutes that govern the activities of insurance holding companies. For example, acquisitions of insurance companies will require not only the approval of domiciliary state regulators, but, depending on the nature of the transaction, may also require approval by the Federal Reserve and the satisfaction of conditions set forth in the Bank Holding Company Act. Likewise, the investments permitted by insurers under state laws may also need to comply with additional (yet-to-be-promulgated) requirements respecting credit concentration limits.

The Dodd-Frank Act authorises the Federal Reserve to tailor its application of enhanced prudential standards to different companies on an individual basis or by category, and the Federal Reserve has stated that it intends to take into account the differences between bank holding companies and nonbank SIFIs, including insurance companies, when applying the enhanced prudential standards required by the Dodd-Frank Act. How the Federal Reserve will ultimately apply the prudential standards to federally supervised insurance-based groups is unclear, but many in the US insurance industry have expressed a concern that the Federal Reserve might apply a 'bank-centric' model with respect to capital and leverage requirements. In response to this concern, late last year Congress enacted the 'Insurance Capital Standards Clarification Act of 2014', which provides that, in establishing the consolidated minimum leverage and risk-based capital requirements mandated under the Dodd-Frank Act, the federal banking agencies shall not be required to include (including for purposes of consolidation) entities regulated by a state or foreign insurance regulator to the extent such entities are acting in their capacity as regulated insurance entities. This act is an important step in clarifying the Federal Reserve's ability to deviate from a bank-centric capital framework with respect to consolidated risk-based capital and leverage requirements for insurance groups subject to its supervision.

The extent to which the Dodd-Frank Act's enhanced prudential standards will supersede, conflict with or duplicate state laws in certain areas, or lead to competitive disadvantages for insurance-based SIFIs, BHCs and SLHCs, will need to be assessed in light of further rule-making by the Federal Reserve and the manner in which the Federal Reserve ultimately applies such standards in the future. It is, however, clear that the regulatory landscape applicable to an insurance-based SIFI, BHC or SLHC is and will continue to be significantly different from that applicable to other US insurers, and any transaction that involves such entities will need to be assessed in light of the federal supervisory framework applicable to them.

International insurance regulatory developments

Developments in the United States relating to group supervision and regulatory capital requirements for insurance companies are occurring in parallel with the development by the FSB and IAIS of new global standards applicable to such institutions.

The standards and policy measures proposed by the IAIS discussed below will, once finalised and implemented into local law, significantly impact the regulatory framework applicable to international insurance groups, as will the implementation of Solvency II for those international insurance groups with operations in the EU. At the present time, however, the manner and timing of implementing the IAIS's insurance regulatory reforms in the US remain uncertain, as does the extent to which the IAIS's capital and other regulatory standards and rules will complement, supplement or otherwise conflict with those developed pursuant to the Dodd-Frank Act and the NAIC's solvency modernisation initiatives. A number of practical issues will also need to be resolved, including how measures applicable to G-SIIs would apply to an entity supervised by a body that is not a member of the FSB (such as a state insurance regulator, rather than the Federal Reserve), which may become an issue to the extent that insurers or reinsurers that may not be designated as SIFIs under the Dodd-Frank Act are designated as 'global systemically important insurers' (G-SIIs).

Many of the IAIS's proposals for the insurance sector described below remain controversial among the US insurance industry, members of Congress, state regulators and the NAIC, particularly with respect to proposed regulatory capital standards, which are viewed by some as favouring a European approach to solvency issues over the risk-based capital approach used by US state regulators. A perceived lack of transparency in the decision-making processes of the IAIS and FSB has also been a source of criticism by members of Congress, the NAIC and industry.

The FSB and IAIS

The FSB consists of representatives of national financial authorities of the G20 nations, various international standard-setting bodies, as well as the International Monetary Fund (IMF) and the World Bank. The US members of the FSB include the Federal Reserve, the Securities and Exchange Commission and the Treasury Department. The G20, the FSB and related governmental bodies have developed 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 financial crisis. FSB member nations agree to undergo periodic peer reviews assessing the soundness and stability of members' financial systems and their implementation of proposed financial regulatory reforms, which are often conducted by means of the Financial Sector Assessment Program (FSAP) reports prepared by the IMF or World Bank.

The IAIS is a voluntary membership organisation of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. US members of the IAIS include the FIO, the NAIC, state insurance regulators and the Federal Reserve. While the policy measures and financial reforms promulgated by the IAIS and the FSB have no legal force unless enacted at the national level, the relevant national financial authorities of members' jurisdictions are, however, expected to implement and enact the policy measures and financial reforms agreed by the FSB and IAIS.

IAIS three tiers of supervision

The IAIS has developed three tiers of supervisory requirements and actions applicable to the insurance industry:

- Insurance Core Principles (ICPs): published in 2011 and revised in October 2013, the ICPs apply to the supervision of all insurers and insurance groups, regardless of size or systemic importance;
- The Common Framework (ComFrame): the latest draft of ComFrame was issued in September 2014 and applies to the cross-border supervision of 'internationally active insurance groups' (IAIGs); and
- G-SII Policy Measures: published in July 2013, these policy measures only apply to insurance groups designated as G-SIIs.

ICPs

ICPs are structured to allow a wide range of regulatory approaches and supervisory processes to suit different markets, and cover a broad range of topics, encompassing, among many other topics, supervisor responsibilities, confidentiality, licensing, change in control, risk management, enforcement and capital adequacy. The IMF issued an FSAP report in March 2015 assessing the observance by US regulators of the ICPs, which found a 'reasonable level of observance' of the ICPs in the United States, but criticised a lack of compliance with certain ICPs and endorsed more federal government involvement in US insurance regulation.

ComFrame

At the direction of the FSB, the IAIS is developing ComFrame as a model framework for the supervision of IAIGs that contemplates 'group-wide supervision' across national boundaries. The IAIS is seeking to promote the financial stability of IAIGs by endorsing:

- uniform standards for insurer corporate governance and enterprise risk management;
- a framework for group capital adequacy assessment that accounts for group-wide risks;
- additional regulatory and disclosure requirements for insurance groups; requirements to conduct group-wide risk and solvency assessments (ORSA); and
- the establishment of ongoing supervisory colleges.

Implementation of ComFrame is scheduled to begin in the last quarter of 2018, and will be subject to revision through prior field testing intended to continue through 2016. ComFrame is concerned primarily with the ongoing supervision of IAIGs, and is not focused on whether an insurance group is systemically important or on how to reduce the systemic risk of insurers (which is the focus of the G-SII Policy Measures and related assessment methodologies).

An IAIG is defined as a large, internationally active group that includes at least one sizeable insurance entity. The IAIS does not intend to develop a definitive list of IAIGs, but has proposed quantitative criteria for national supervisors to assess on a regular basis whether they should apply ComFrame to an insurance group. It is estimated that approximately 50 to 60 firms from around the world would qualify as IAIGs under the current proposed criteria, including all designated G-SIIs.

In connection with ComFrame, the IAIS is in the process of developing a risk-based global insurance capital standard (ICS) applicable to all IAIGs. The first public consultation draft for the ICS was published by the IAIS in December 2014. ComFrame, including the ICS, is scheduled to be finalised and adopted by the IAIS in the fourth quarter of 2018, although there are indications that the ICS will not be fully developed and implemented by that time.

G-SIIs

G-SIIs are defined by the FSB and the 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, in July 2013 designated nine life and composite insurers as G-SIIs (three of which are US-based), and redesignated the same nine insurers in November 2014. G-SIIs are designated on an annual basis each November. The FSB and the IAIS have yet to designate any reinsurers as G-SIIs, and the FSB has indicated that such designations will be delayed for the near future pending further assessment.

G-SII designations were based on an assessment methodology developed by the IAIS. Drivers of systemic importance under the IAIS's assessment methodology include size, global activity, interconnectedness, 'non-traditional/non-insurance' (NTNI) activities and substitutability. The assessment methodology and many of the key G-SII Policy Measures hinge on the degree of NTNI activities undertaken by a G-SII and its subsidiaries, and the degree to which NTNI activities have been effectively separated from traditional insurance activities. According to the IAIS, NTNI activities and products tend to involve leverage, liquidity or maturity transformation, imperfect transfer of credit risks, and credit guarantees or minimum financial guarantees, and often are more financially complex than traditional insurance in the shifting of financial market risk to insurers. Examples cited by the IAIS include variable annuity or life insurance products with minimum guarantees, certain insurance-linked securities, GICs and synthetic GICs, as well as securities lending and repurchase activities outside the scope of traditional insurance activities.

The G-SII Policy Measures promulgated by the IAIS and endorsed by the FSB include:

- 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 (eg, to limit or eliminate systemically important activities or limit the use of affiliate reinsurance for NTNI lines of business);
- enhanced capital standards, including basic capital requirements (BCR) applicable to all group activities and, for business deemed to be NTNI, higher loss absorption capacity requirements (HLA), such that additional capital will be required to be held for NTNI activities (especially to the extent such activities have not been 'effectively separated' from traditional insurance activities);
- systemic risk management plans: group-wide supervisors are to oversee the development by G-SIIs of plans for managing, mitigating and possibly reducing systemic risk, which may include the effective separation of NTNI activities from traditional insurance businesses;
- enhanced liquidity planning and management: group-wide supervisors are to require a regular gap analysis of liquidity risks and adequacy of available liquidity resources under normal and stressed conditions; and
- effective resolution regimes: the FSB has developed a document entitled the Key Attributes of Effective Resolution for Financial Institutions, the most recent version of which was published in October 2014, which includes the key features of resolution regimes that should be applied across jurisdictions to systemically significant financial institutions; the IAIS has developed an annex to this document that outlines the key attributes that should apply to the resolution of G-SIIs .

Under the insurance-sector specific elements of the Key Attributes, G-SIIs will be expected to develop and prepare recovery and resolution plans to be submitted to their group-wide supervisors on an annual basis. In addition, 'crisis management groups' are expected to be established that will include the relevant supervisory authorities, central banks, resolution authorities, finance ministries and guarantee fund authorities of each G-SII, as a forum for relevant regulators to discuss enhancing preparedness for the potential failure of the G-SII. Moreover, resolvability assessments are to be conducted by the home authority and crisis management group of each G-SII to assess the feasibility of the G-SII's resolution strategies. Finally, institution-specific cross-border cooperation agreements are to be developed and entered into among the G-SII's relevant resolution authorities.

Capital standards and requirements

The capital framework to be applied to G-SIIs and IAIGs under the IAIS proposals, when finalised and implemented domestically, will likely have significant implications for US-based insurance groups. The various capital standards and requirements are currently expected to be implemented in late 2018 or 2019, and the IAIS envisages that the ICS may eventually replace the BCR as the foundation for HLA.

The IAIS's capital standards and requirements proposed to date have generally been based on a market-adjusted valuation approach, and are predicated on the utilisation of comparable accounting standards and practices among the jurisdictions in which G-SIIs and IAIGs operate. In effect, the IAIS envisages that IAIGs and G-SIIs will comply with the required risk-based capital ratios and maintain capital at the consolidated group-level based on GAAP or IFRS as applicable, which will require that certain elements of IFRS and GAAP converge with respect to the accounting treatment for certain types of insurance liabilities and assets (a convergence that is underway but has yet to be completed successfully).

Solvency II

Solvency II is a European Union directive (enacted in 2009) that is intended to codify and harmonise EU insurance regulation. The implementation of Solvency II in the EU has been subject to numerous delays but is now, following the adoption of the Omnibus II Directive in April 2014, scheduled for full implementation by January 2016. Solvency II is based on three pillars of enhanced regulation:

- Pillar 1 addresses quantitative measures to ensure insurance firms are adequately capitalised with risk-based capital, including requirements relating to technical provisions (ie, reserves) and solvency capital and minimum capital requirements;

- Pillar 2 addresses qualitative measures, governance, risk management and supervisory interaction, including a requirement that firms conduct an ORSA; and
- Pillar 3 covers enhanced supervisory reporting and public disclosure requirements.

Solvency II also contains provisions designed to strengthen the supervision of insurance groups, including establishment of colleges of supervisors and imposing group-based capital requirements in addition to capital requirements for individual insurers. As group supervision may include groups headquartered in non-EU jurisdictions, or include subsidiaries of a EU-based group located in non-EU jurisdictions, Solvency II permits group solvency and capital calculations to take account of local capital standards and requirements in relevant non-EU countries where members of the group are domiciled, provided the supervisory regime of the non-EU jurisdiction involved has been assessed as 'equivalent' by the European Commission or (absent an equivalence assessment by the European Commission) the relevant EU group supervisor. In the absence of equivalence, the relevant non-EU insurer will be consolidated with the group's EU operations for purposes of applying the Solvency II minimum capital and solvency requirements. Although to date the US supervisory regime has not been assessed as fully equivalent, the European Commission's third country equivalence decisions adopted in June 2015 granted the US insurance regulatory regime, as well as the regimes in five other countries, provisional equivalency for a period of 10 years with respect to the 'solvency calculation' area of Solvency II (but not the 'group supervision' or 'reinsurance' areas). The provisional equivalence will allow EU insurers with subsidiaries in these six countries to use local rules, rather than Solvency II rules, to carry out their EU prudential reporting for these subsidiaries. It is possible that the less than full-equivalency determination with respect to the US could result in additional regulatory requirements for US insurance groups doing business in the EU.

* *Samuel R Woodall, Robert M Fettman and Roderick M Gilman provided valuable assistance in the preparation of this Introduction.*

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