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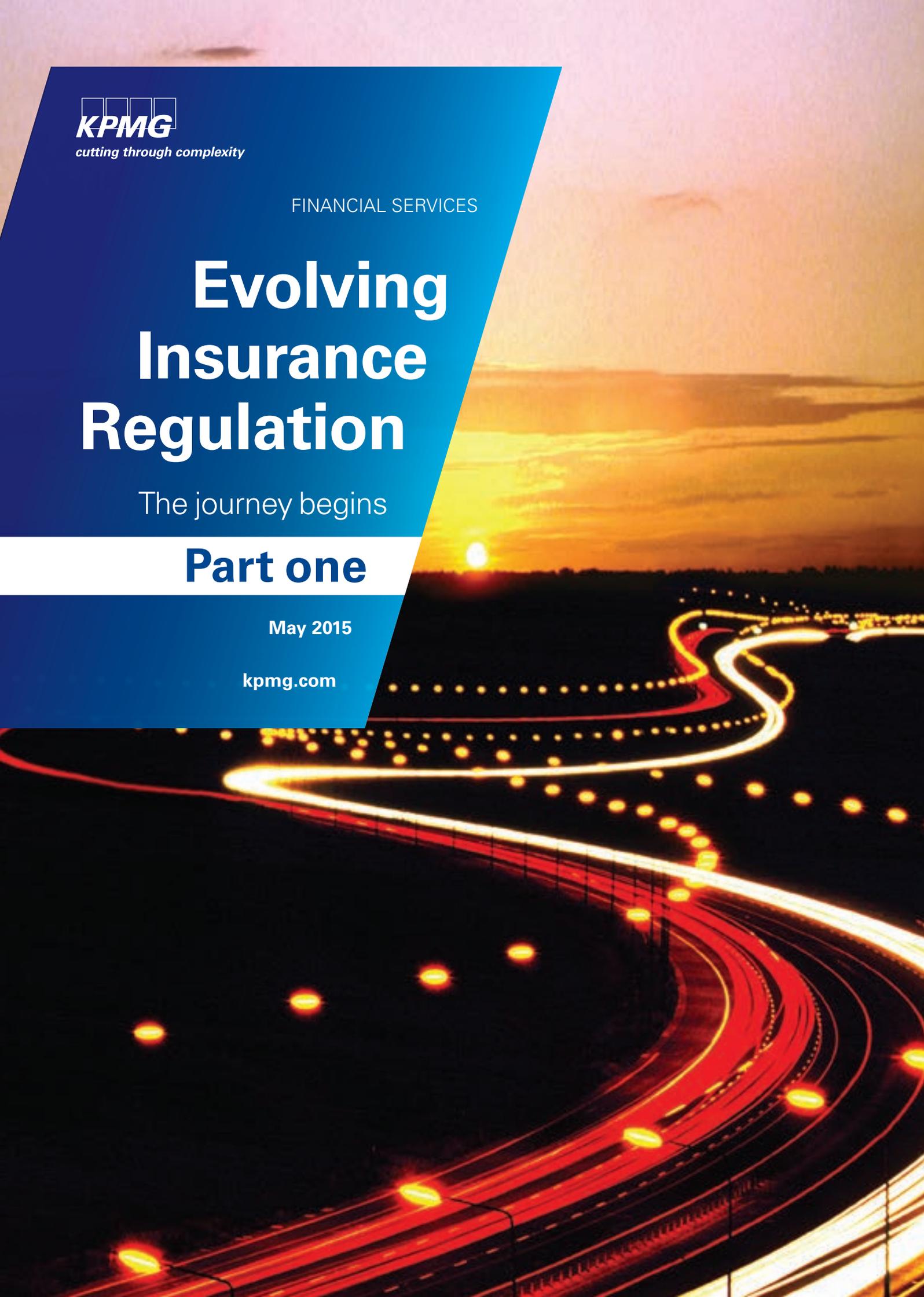
Evolving Insurance Regulation

The journey begins

Part one

May 2015

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ABOUT THIS REPORT

This report is part of a regional series developed by KPMG's network of regulatory experts. The insights are based on discussion with our member firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies in each region. *Evolving Insurance Regulation – The journey begins* is produced in two parts this year.

Part one considers the international developments that are dominating regulatory change and includes key insights from regulators and industry practitioners.

Part two looks at the regional regulatory developments by country (where available) to provide local insights on the shape of our industry in each market.

For other regional reports, please contact fsregulation@kpmg.co.uk or see www.kpmg.com/regulatorychallenges

GLOBAL INSURANCE LEADERSHIP TEAM



Gary Reader
Global Head of Insurance and EMA region Coordinating Partner
KPMG in the UK



Laura Hay
Americas region Coordinating Insurance Partner
KPMG in the US



Simon Donowho
ASPAC region Coordinating Insurance Partner
KPMG in China



Frank Pfaffenzeller
Joint Global Insurance Audit Lead Partner
KPMG in Germany



Frank Ellenbürger
Joint Global Insurance Audit Lead Partner
KPMG in Germany



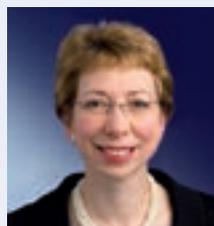
Brian Daly
Global Insurance Tax Lead Partner
KPMG in Ireland



Ferdia Byrne
Global Insurance Actuarial Lead Partner
KPMG in the UK



Rob Curtis
Global Insurance Regulatory Lead Executive Director
KPMG in Australia



Mary Trussell
Global Innovation and Emerging Markets Lead Partner
KPMG in Canada



Sam Evans
Global Insurance Deal Advisory Lead Partner
KPMG in the UK



Mike Walker
Global Insurance Restructuring Lead Deal Advisory
KPMG in the UK



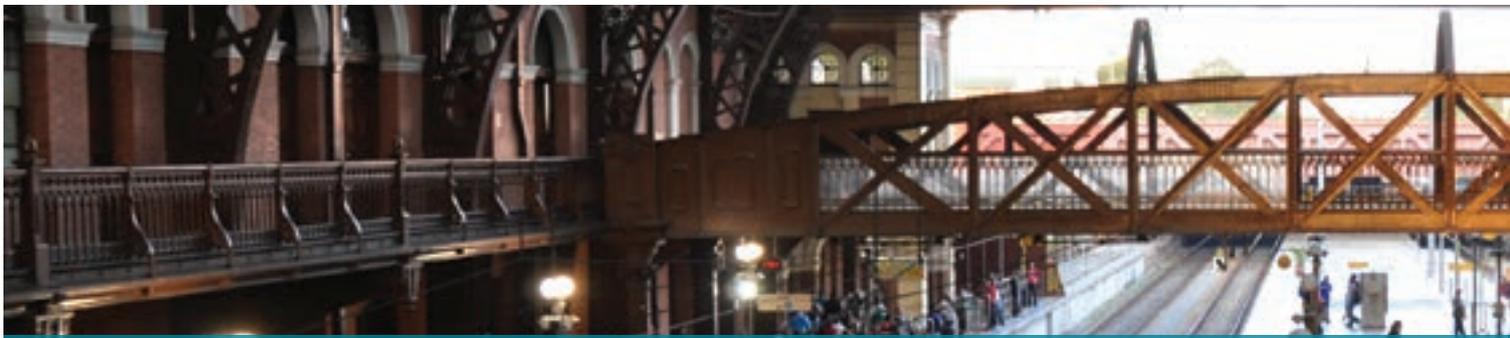
Mark Longworth
Global Insurance Management Consulting Lead Partner
KPMG in the UK



Matt Mccorry
Global Insurance Risk Consulting Lead Partner
KPMG in the US

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Foreword



Jeremy Anderson

Chairman KPMG's Global Financial Services practice



Gary Reader

Global Head of KPMG's Insurance practice

Welcome to the fifth edition of *Evolving Insurance Regulation*. We have been reporting for a number of years on how insurance regulation continues to evolve, with ongoing regulatory developments – particularly at the global level and the impact such changes will have for insurers. However, the recent (December 2014) release by the International Association of Insurance Supervisors of its consultation paper on the proposed new global insurance capital standard, the implementation of Solvency II, and the expected completion of IFRS 4 Phase 2 potentially mark the birth of a new era in global insurance regulation.

Given the importance of these developments to the international

community, we have explored the potential implications with leading regulators and chief risk officers from some of the largest global insurance groups this year. We share with you their unique insights, views and perspectives on some of the key challenges and opportunities which exist in the development of a global regulatory framework.

This year we have also expanded our coverage of ongoing developments at regional and local levels as the amount of regulatory change is unprecedented. We consider the cross sectoral influence in the areas of risk management and consumer protection, as well as considering the impact of accounting developments.

At a glance – Global implications for insurers

- Supervisors are increasingly looking beyond the boundary of the regulated insurer to the wider group and holding company operations. New governance, reporting and capital requirements will be enacted around global requirements.
- Systemic concerns are not abating and additional G-SIIs are likely to be named and subject to increasingly intrusive requirements. Expansion of the requirements to domestically significant insurance operations is likely to follow.
- Insurance critical functions are viewed as part of essential services which must be maintained or run down in an orderly fashion. Insurers will need to invest more in resolution and contingency planning as a result.
- Boards must be able to demonstrate that their risk governance procedures, especially in regards to risk culture, permeates all levels of operations, sales and management.
- Conduct regulation will continue to increase and will be expanded to product design, marketing and incentive policies.



The journey begins

The release in December 2014 of the International Association of Insurance Supervisors (IAIS) consultation paper on a risk-based global insurance capital standard (ICS) marks a significant milestone in the journey towards consistency in the assessment of global insurance groups. Unlike banking, the insurance sector does not have a global regulatory framework, resulting in bespoke regulatory requirements in each jurisdiction. While the ICS will only apply to international groups, we have long supported any move to reduce duplication and inconsistency in regulatory requirements. Unfortunately, we are concerned that the ICS, as presently proposed, could just add another layer of complexity and does little to address this issue, since its application is solely at the group level and legal entity regulatory requirements will be unaffected.

Quantitative Capital Requirements

As proposed, the ICS will form part of the quantitative capital requirements that will apply on a group-wide, consolidated basis to around 50 of the largest international insurance groups. The Financial Stability Board (FSB) has provided the IAIS with a mandate to develop the ICS and the IAIS had originally committed to do so by 2018, but has recently announced that the 2018 standard will be an interim standard. The IAIS will continue to work on the ultimate goal of full comparability,

but for the moment recognizes that more time is needed to reach that objective.

Prior to this December release, the enhancements in global solvency supervision have primarily been directed at the nine Global Systemically Important Insurers (G-SIIs). To that end, the IAIS consulted on its proposals regarding the Basic Capital Requirement (BCR) in July 2014 (finalized October 2014) and, in September 2014, published the principles for the development of Higher Loss Absorbency (HLA) requirements (consultation on which is now expected mid-2015). These developments arose from the events of the Global Financial Crisis, where the FSB, acting on a mandate from the G20, sought better supervisory outcomes for all systemically important financial institutions and requested the IAIS (as the insurance international standard setter) to develop an appropriate insurance response for the supervision of G-SIIs. We have generally endorsed these recommendations.

Feeling the impact

The ICS, by contrast, will apply to all Internationally Active Insurance Groups (IAIGs) and not just the G-SIIs. Due to its broad application, the ultimate form of the ICS remains worryingly unclear. While the ICS should move the industry one step closer to achieving convergence and establishing clear standards for capital and risk

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While we have generally endorsed the IAIS' responses to capital and systemic risk, we have also maintained the view that consistency in group supervisory approaches, especially as regards achieving similar outcomes from supervisory colleges, is perhaps even more paramount.

management, it is very likely that further regulatory reform may be required to ensure that it is consistent and results in a framework that can be effectively implemented.

In particular, the practical application of ICS by supervisors will be as important as the requirements themselves. The relationship between the ICS at group level and local regulatory requirements at solo level will be critical. Since the ICS will not apply at a legal entity level, groups will face additional challenges in managing both solo and group requirements. Further, the fact that the standards set a minimum standard will mean that local supervisors must demonstrate that their own groups regime is at least as strong as the ICS or locally headquartered groups will face an additional layer of reporting requirements, coupled with confusion as to which becomes their binding requirement. This overlap raises the very real prospect of inconsistent application of the ICS and divergent group capital standards across geographies, running counter to the IAIS's aim of promoting global convergence, consistency and reduction of capital arbitrage. Such an outcome would be most unfortunate.

The debate continues

Further, insurance groups will want to ensure that inefficiencies and duplication are not inadvertently built into the new requirements. Consideration amongst regulators concerning important issues, such as capital target criteria, time horizon and measurement basis, will be required. We remain active participants in encouraging a mature and engaged debate within the insurance sector regarding these key issues.

Similarly, it will be critically important that the ICS incorporates consistent valuation principles for assets and liabilities and a consistent definition of qualifying capital resources that are meaningful across all markets and which do not create undue balance sheet volatility. The failure of the IASB

and FASB to converge on a single accounting standard for insurance has increased the difficulty of this task.

As Solvency II in Europe has demonstrated, achieving significant regulatory reform is often difficult, can involve protracted negotiations and consume extensive resources and costs. This made the deadline for finalization of the ICS by December 2016 appear overly optimistic - especially as detailed and thorough industry participation and involvement is expected, including years of quantitative field testing. We applaud the IAIS for recognizing that a longer timeframe may be required to ensure all stakeholders can effectively address the challenges involved if a single group capital requirement is to be established.

While we have generally endorsed the IAIS' responses to capital and systemic risk, we have also maintained the view that consistency in group supervisory approaches, especially in regards to achieving similar outcomes from supervisory colleges, is perhaps even more important.

Greater consistency still required

A global ICS will require greater consistency in approaches to group supervision. If the IAIS is to achieve its convergence goals, it is likely that regulatory changes to introduce or refine group-wide supervision may be required in some markets. For example, there are significant differences between the US 'windows and walls' approach and the European group supervisory approach under Solvency II. Within Europe, the ICS developments will present an opportunity for a debate on the role of the European Insurance and Occupational Pensions Authority (EIOPA) in relation to the group-wide supervision of European IAIGs. We support broadening EIOPA's remit to facilitate an enhanced centralized oversight role, particularly regarding group-wide supervision activities



for these groups. In the meantime, countries in Latin America, Africa and Asia are looking to both Europe and the IAIS for guidance on reforms.

The International Monetary Fund (IMF) and World Bank's Financial Sector Assessment Program (FSAP) based on the Insurance Core Principles (ICP) are doing much to encourage changes in the areas of risk-based supervision, better governance and increasingly conduct risk, all of which we support.

Currently, however, there is little consistency in conduct regulation and consumer protection measures, either within Europe or across global geographies. Such inconsistency in regulatory approaches is unhelpful, especially as what drives regulatory action (particularly in times of crisis) is often dictated by the need to protect local policyholders. For example, Europe has the opportunity to address this through the establishment of a consistent European-wide policyholder protection scheme to provide policyholders with greater protection against conduct risks as well as

prudential risks. While Solvency II will ensure that all insurers within Europe are prudentially sound, compensation to policyholders is more likely to arise from failures in the way business is conducted.

Key insights

To provide additional perspectives, this year we sought the views from some of the world's leading regulators and industry practitioners concerning the ICS and related implementation issues. Their insights are outlined on pages 36 to 45. It is clear from our interviews that while there is support for greater consistency and convergence in international insurance requirements amongst all stakeholders, significant concern exists amongst CROs regarding the prospect of an ICS and importantly, how the global framework is to be implemented. Our interviews provide great insight into current thinking and future direction of insurance regulation – immensely relevant given we are on the cusp of witnessing the birth of a new era of global supervision.

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Executive Summary: a global perspective

“In this edition, we highlight the latest IAIS initiatives and other industry developments and analyse the impact that such changes may have on the insurance sector and outline how firms can best prepare themselves to meet these new challenges.”

International developments dominate regulatory changes

The last few years have seen the IAIS lay the foundation for change through the establishment of the Insurance Core Principles (ICPs), the identification of G-SIIs and the development of its Common Framework (ComFrame) relating to the supervision of Internationally Active Insurance Groups (IAIGs). Even though these proposals have done much to improve insurance supervision, the establishment of a single capital standard has continued to be a divisive issue. In spite of the strong differences in opinions on ICS, during 2014 the IAIS took significant steps towards the development of a group-wide capital standard through the publication of the basic capital requirement (BCR), which will apply to the nine G-SIIs, and the release of its first consultation on a risk-based insurance capital standard (ICS).

In this edition, we highlight the latest IAIS initiatives and other industry developments and analyse the impact that such changes may have on the insurance sector, outlining how firms can best prepare themselves to meet these new challenges.

ComFrame

A stable version of ComFrame was released in 2014 as the basis for both qualitative and quantitative field testing to continue throughout this year. Thirty-six companies are participating in the tests, including all G-SIIs. A revised version of ComFrame will be released for consultation at the end of 2015.

- **Insurance Core Principles and latest Financial Sector Assessment Program developments**

The International Monetary Fund (IMF) completed six new FSAPs using the 2011 ICPs during 2014. Through these, it continued to push for more

active regulation of intermediaries, pro-active enforcement in the area of market conduct, and improved group supervision. At the same time, the IAIS has been conducting self-assessment peer reviews as a basis for further guidance and revisions to the ICPs. We summarize the FSAPs in this chapter and provide details in the specific country updates.

• **Global Insurance Capital Standard**

The IAIS consultation paper on the global insurance capital standard (ICS) focuses heavily on the standard formula to be used, delaying decisions on the use of internal models and mutual recognition into 2016. Using a total balance sheet approach as a starting point, the IAIS has proposed a market-adjusted valuation approach, although it is also collecting data on a GAAP plus adjustments basis.

• **Regulation for G-SIIs**

Although no additional G-SIIs were named in 2014, the process has begun to reassess the selection methodology particularly through an examination of critical functions. These functions will also be essential to the recovery and resolution planning that is now being required of G-SIIs. The main development in 2014 was the release of the Basic Capital Requirement (BCR), a factor based methodology which will become effective in 2015. We review this approach in depth. The IAIS is now beginning work on a Higher Loss Absorbency (HLA) calculation to be applied in 2019. The primary objective is to look at higher charges for non-traditional and non-insurance risks.

Perspectives from key regulators and chief risk officers on global developments

KPMG asked prominent regulators and CROs to comment on the direction insurance regulation is taking and the

prospects for the future. Highlights of the discussion can be found on pages 36 to 45, and cover the chances of achieving a global capital standard, its role as a Basel III type accord, the possibility of requiring recovery and resolution plans for domestic systemically important insurers, the performance of supervisory colleges and the future of insurance regulation.

Regional regulatory developments

• **Americas region**

Although the changes taking place in the Americas vary greatly between North and South America, often the same issues are being addressed and moving in a similar direction.

In the United States, the National Association of Insurance Commissioners (NAIC), Federal Insurance Office (FIO) and Federal Reserve Board (FRB) are cooperating on the development of a group capital standard, but “Team USA” is far from finding a common approach. In the meantime, spurred by the 2015 FSAP of US financial regulation, the NAIC continues to implement changes to laws regarding Own Risk and Solvency Assessment (ORSA), group supervision, corporate governance, and market conduct. However, adoption by the states is uneven and will take several years.

Canada, having just completed its 2014 FSAP, is working to address concerns raised regarding risk management, conduct of business and group supervision, while Bermuda is completing its reforms for Solvency II equivalence.

Latin American countries, especially Mexico, Chile and Brazil are instituting risk focused solvency systems. There is less conduct risk activity as of yet in these countries, but it is being discussed.

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• **Asia-Pacific (ASPAC) region**

Across the Asia-Pacific region, 2014 witnessed increased supervisory attention to risk-based supervision, corporate governance, group-wide supervision, non-insurance activities, and data reporting. In 2015 this region will see a continued regulatory push to developing economic valuation frameworks and improving risk management frameworks.

• **Europe, Middle East and Africa (EMA) region**

The looming effective date for Solvency II dominates all activity in Europe. Level 2 delegated acts (now known as Commission Delegated Regulation 2015/35) were approved in January 2015 and Member States will transpose the directive requirements into local requirements by the end of March, prior to opening for the various approval applications on 1 April 2015. Equivalence decisions are now expected to be released in 2015 in two waves.

In Africa the focus has been on implementing the Insurance Core Principles. Health insurance and micro-insurance continue to be areas of focus. South Africa is undergoing significant changes in both market conduct and prudential regulation. The Twin Peaks Model will go into effect this year.

Conduct risk – The evolving nature of conduct risk and regulatory expectations

Once a subset of operational risk, conduct of business risk is now being addressed as an independent discipline. The IMF and others are pushing for a more pro-active approach to conduct risk, including data collection on complaints, on-site inspections, and product and marketing regulations. We

explore the impact this is having. The IAIS is expanding its guidance in the area and involving consumer groups in the process. Conduct supervisors are becoming better organized, allowing them to share their tools and models internationally. In 2014 a number of jurisdictions made substantial changes in the conduct area as detailed in our regional reports. The overall result is that insurers will increasingly need to have a ‘customer first’ approach.

Risk management insights – The rising importance of risk culture

Regulators, led by the Financial Stability Board (FSB), are pushing companies to develop a corporate risk culture, including a clearly defined risk appetite framework. In this chapter we explore these regulatory changes and best practices firms should consider in responding to them. We look particularly at risk culture as the central factor in risk management.

The impact of accounting changes on regulation

The International Accounting Standards Board (IASB) was hoping to complete the insurance contracts standard by late 2015 or early 2016, but has recently delayed this and the timetable is currently unclear. Its work will continue without the US Financial Accounting Standards Board (FASB). The IASB still has work to do to finish on time, including the thorny issue of participating contracts and final decisions on volatility and coordination with IFRS 9. As a result, it now appears that IFRS 4 Phase 2 is unlikely to be released in time to be used by the IAIS as the valuation basis for its 2018 interim capital standard although there may eventually be some convergence.



The year ahead

No one can dismiss the massive impact that global regulation and global organizations are having on the shape of local supervision. Entities such as the G-20, the FSB, the OECD, the IAIS, the IMF and the World Bank are all driving change in local regulation. Whether those changes will result in a single capital standard is not clear, but all other aspects of insurance regulation are converging from solvency and governance requirements to risk management and conduct issues.

In the next year the sector will see more focus on the actual operational issues of companies including structure, compensation, marketing, and products themselves. We have highlighted some of these developments in the chapters on conduct and risk. Much of the reform in insurance since the crisis has been driven by banking regulation, but in the future we are likely to see marketing, disclosure and compensation requirements emanating from securities regulation instead.

What is clear is that these proposals herald significant change and will usher in a new era of global supervision. **Are you prepared?**

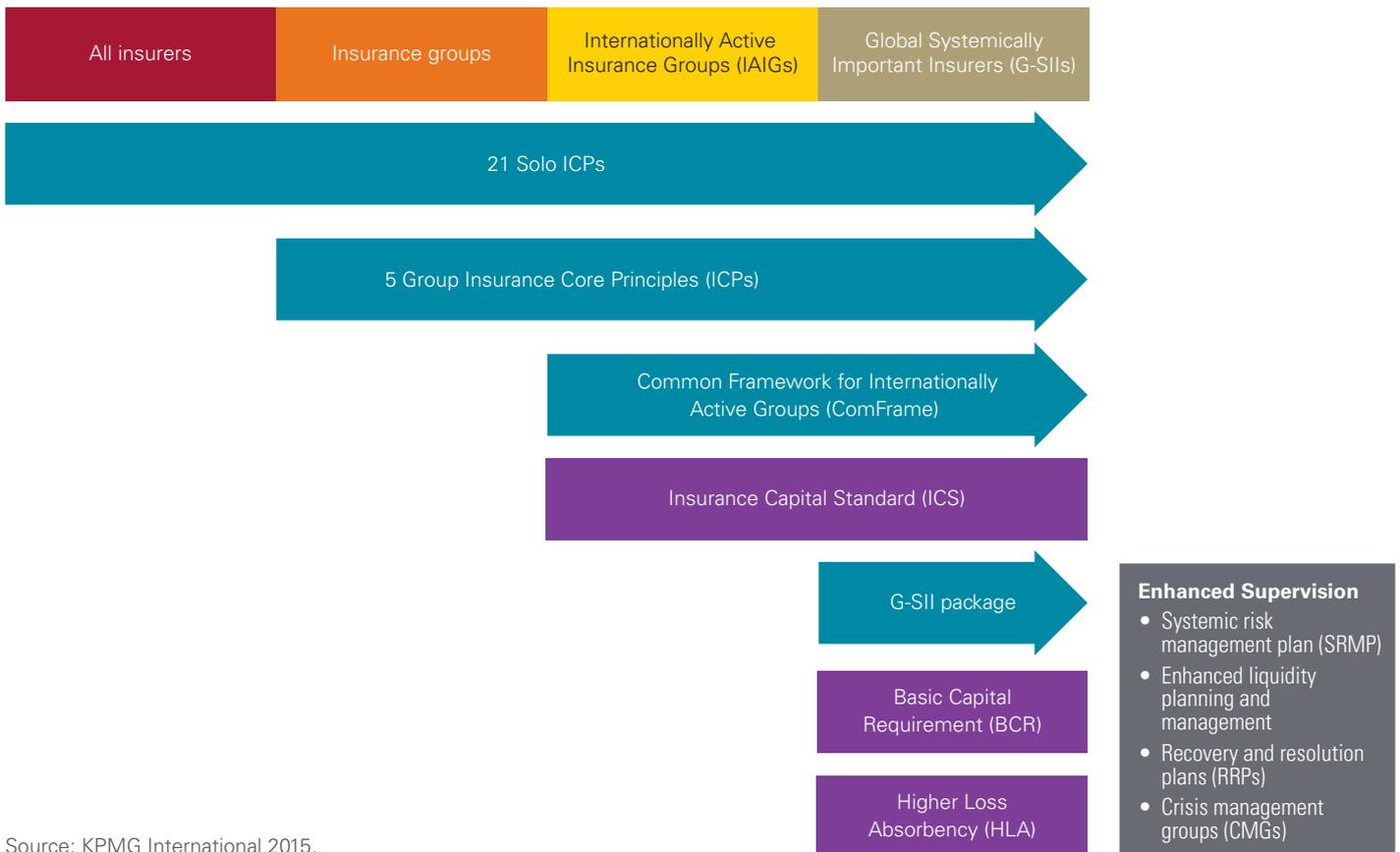
International developments dominate regulatory changes

2015 will see the continuation of a number of key initiatives being advanced by the IAIS and the FSB. These initiatives are being developed in parallel, although they are at various stages of maturity. In this section, we assess the impact these key proposals may have on insurers, especially in regards to ComFrame, the Insurance Core Principles – including the latest update on the IMF’s FSAP activities, the global insurance capital standard, G-SIIs and the development of the basic capital requirement.

While ComFrame applies at both solo and group level, the BCR, HLA and ICS requirements will only be applied at group level. G-SIIs are subject to

additional enhanced supervision and recovery and resolution plans. This can be viewed in Figure 1 below.

Figure 1: Application of ComFrame and IAIS capital initiatives to different types of firms/groups



Source: KPMG International 2015.

ComFrame

The development of ComFrame began in 2009, building upon and expanding the existing insurance core principles. The work involved defining the scope of ComFrame (all IAIGs, which are themselves defined based on size and jurisdictional reach), establishing both the standards that must be met by those IAIGs and the group supervisory requirements. As such, ComFrame represents the globally accepted requirements for the supervision of IAIGs with a specific emphasis on group-wide supervision.

In June 2014, the IAIS released a “stable version” of ComFrame for the purposes of field testing the concepts and the capital calculations. With 36 insurance companies participating in the tests over the next three years, the results will be used to adjust both the quantitative and qualitative features of ComFrame before it comes into effect in 2019.

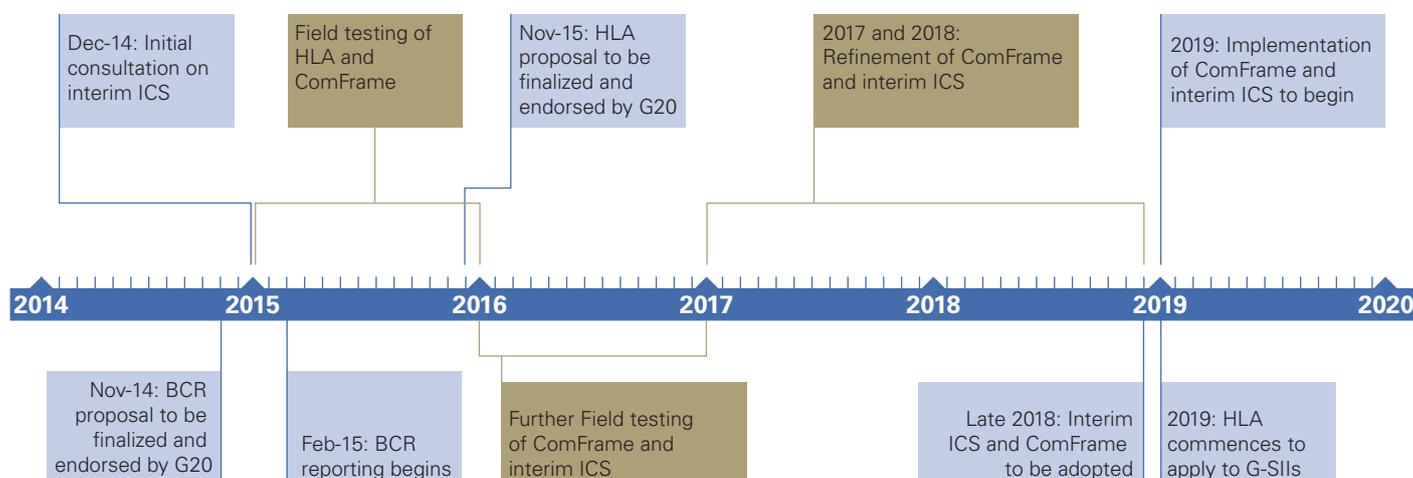
The qualitative tests aim to understand the gaps that may exist between current supervisory practices and the provisions of ComFrame and the potential incremental costs of

implementation. The quantitative review aims to establish the valuation methodology, calibration and capital requirements for ComFrame.

Testing is taking place in several phases. The first quantitative phase, which ran from March to August 2014, looked at valuation and stress tests. These results informed both the determination of the BCR, which was released in final form in October 2014, and the ICS. The next phase was a qualitative review of corporate governance, investments and risk management issues which began in October 2014. In 2015, there will be additional qualitative and quantitative tests. With the recent decision by the IAIS to lift the 2019 deadline for ICS, there is likely to be an interim capital standard effective in 2018 while work on an ultimate converged standard continues over several more years.¹ The ultimate goal of a single ICS will include a common methodology by which one ICS achieves comparable, i.e. substantially the same, outcomes across jurisdictions.

The current timeline of the various IAIS activities is shown below:

Figure 2: Current timeline of various IAIS activities



Note: As reported in the March 2015 IAIS Newsletter.

1. IAIS Executive Committee decision February 2015

/// The IAIS ICPs are high-level principles-based standards whereby members of the IAIS (predominantly most of the world's national regulators) are expected to implement the ICPs into their national supervisory frameworks. ///

Scope of Group Supervision

Two of the main open issues in ComFrame have been the definition of an insurance group and the level of authority a group-wide supervisor has over portions of the group, particularly the head of the insurance group and non-insurance activities.

The IAIS has decided that the group-wide supervisor must have "direct" powers at the level of the head of the insurance group.² These changes are now being incorporated into revisions of the ICPs and are reflected in the September 2014 version of ComFrame. This detailed authority will include:

- Direct power to request information from the head of the insurance group, including information on subsidiaries relevant to the overall risk of the IAIG
- Direct power to conduct on-site inspections at the head of the insurance group
- Direct power to request formal discussions with members of the governing body, senior management and key persons in control functions of the head of the insurance group without regard to which legal entity within the group employs them
- Direct power to perform fit and proper assessments of members of the governing body, senior management and key persons in control functions of the head of the insurance group.

Insurance Core Principles and latest FSAP activities

The IAIS ICPs are high-level principles-based standards whereby members of the IAIS (predominantly most of the world's national regulators) are expected

IAIS Working Definitions for ComFrame³

Insurance Group: Two or more legal entities under common control, of which at least one is an insurance legal entity, and the primary function of those taken together is insurance.

Head of the Insurance Group: The legal entity that controls the insurance group.

The Head of the IAIG: The entity that controls or exerts dominant influence over the insurance group. It is usually the ultimate parent or, if the insurance group is a subset of a conglomerate, the head of the insurance group within the conglomerate.⁴

to implement the ICPs into their national supervisory frameworks. Failure to do so risks receiving an adverse finding from the IMF/World Bank who conduct Financial Sector Assessment Program (FSAP) reviews, which principally assess the extent to which national supervisory frameworks are consistent with the ICPs.

There are currently 26 ICPs which can be divided into five broad categories covering:

- Supervisory powers and measures
- Solvency
- Group supervision, cooperation and crisis management
- Conduct of business, intermediaries and fraud prevention
- Corporate governance and public disclosure

2. IAIS Insurance Group Working Group, December 2014

3. Ibid.

4. IAIS ComFrame September 2014

Table 1: Five categories of the ICP core principles

Supervisory Powers and Measures	Solvency	Group Supervision, Cooperation and Crisis Management	Conduct of Business, Intermediaries and Fraud Prevention	Corporate Governance and Public Disclosure
ICP 1 Objectives, Powers and Responsibilities of the Supervisor	ICP 13 Reinsurance and Other Forms of Risk Transfer	ICP 3 Information Exchange and Confidentiality Requirements	ICP 18 Intermediaries	ICP 5 Suitability of Persons
ICP 2 Supervisor	ICP 14 Valuation	ICP 23 Group-wide Supervision	ICP 19 Conduct of Business	ICP 7 Corporate Governance
ICP 4 Licensing	ICP 15 Investment	ICP 24 Macroprudential Surveillance and Insurance Supervision	ICP 21 Countering Fraud in Insurance	ICP 8 Risk Management and Internal Controls
ICP 6 Changes in Control and Portfolio Transfers	ICP 16 Enterprise Risk Management for Solvency Purposes	ICP 25 Supervisory Cooperation and Coordination	ICP 22 Anti-Money Laundering and Combating the Financing of Terrorism	ICP 20 Public Disclosure
ICP 9 Supervisory Review and Reporting	ICP 17 Capital Adequacy	ICP 26 Cross-border Cooperation and Coordination on Crisis Management		
ICP 10 Preventive and Corrective Measures				
ICP 11 Enforcement				
ICP 12 Winding-up				

Source: Insurance Core Principles Standards Guidance and Assessment Methodology, October 2011 revised October 2013.

As can be seen from Table 1, there is a strong focus within the ICPs towards prudential matters, with just the one ICP (19) on conduct of business, which contains 13 high level principles-based standards (see conduct chapter for further details).

The Financial Sector Assessment Program

As part of the response to the global financial crisis, the IMF and World Bank

FSAP reviews of different countries' financial sectors have become more important. In those countries whose financial systems have been deemed by the IMF to be systemically important (see Table 2), FSAP assessments are now mandatory and should occur every five years. For other jurisdictions, this remains a voluntary process.

Table 2: Systemically important financial countries and year of assessment

Systemically Important Financial Countries and Year of Assessment

Australia (2012)	<i>Denmark (2014)</i>	Ireland (2006)	Netherlands (2011)	Sweden (2011)
Austria (2013)	<i>Finland (2001)</i>	Italy (2013)	<i>Norway (2005)</i>	Switzerland (2014)
Belgium (2013)	France (2012)	Japan (2012)	Poland (2013)	Turkey (2011)
Brazil (2012)	Germany (2011)	Korea (2014)	Russian Federation (2011)	United Kingdom (2011)
Canada (2014)	Hong Kong SAR (2014)	Luxembourg (2011)	Singapore (2013) United States (2015)	United States (2015)
China (2011)	India (2012)	Mexico (2011)	Spain (2012)	

Source: Country list from IMF, 'Mandatory Financial Stability Assessments under the FSAP,' 24 September 2014.

Note: The countries shown in italics were only added to the list in January 2014. Assessment of countries in bold were based on the revised 2011 ICPs.

These reviews include an emphasis on considering the extent of compliance with relevant international standards, which for the insurance business means an assessment of compliance with ICPs. The result has been that we have seen a global drive among regulators over recent years to meet ICP compliance, which is a theme that comes through in our country analysis later in this paper. In addition to the mandatory reports, the IMF and World Bank also conduct voluntary assessments of countries upon request.

In our 2014 report we summarized the results on the first ten FSAPs completed using the ICPs as revised in 2011. This year we include six additional countries whose reviews were published in 2014/2015. The new reports indicate a continued emphasis on onsite inspections, disclosure, market conduct, and active supervision of intermediaries. Several of the reports also look more closely at regulatory oversight of intra-group transactions and investments. One interesting issue raised in the Swiss review relates to the need for increased supervision of third country branches of reinsurers.

ICP Revisions

In 2015 the IAIS will propose revisions for a number of ICPs based on the self-assessment process undertaken by the IAIS over the past five years. In order to minimize confusion for the FSAPs, the IAIS has decided to cluster the revisions together. IAIS working groups are currently developing changes for ICPs 3, 4, 5, 7, 8, 23, and 25 which will be amended in 2015. ICPs 1, 9, 10, 11, 12, and 26 will be changed in 2016, and ICPs 2, 6, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, and 24, will be revised in 2017.⁵

5. IAIS March 2015 Newsletter

Table 3: KPMG Overview of 2014 FSAP Results

ICP/country*	Switzerland	Canada	Hong Kong	Denmark	South Africa	United States
Supervisory Powers and Measures						
1 Powers	3	2	2	2	2	1
2 Supervisor	3	1	1	1	1	1
4 Licensing	2	3	3	3	2	2
6 Control	3	3	3	3	2	3
9 Reporting	2	2	2	2	2	2
10 Correction	3	3	3	3	3	3
11 Enforcement	3	3	2	3	3	3
12 Winding Up	3	3	3	2	1	3
Solvency						
13 Reinsurance	2	2	2	3	2	3
14 Valuation	3	2	2	3	2	1
15 Investment	3	2	3	2	2	3
16 ERM	3	2	1	2	1	2
17 Capital Adequacy	3	2	1	2	2	2
Group Supervision, Cooperation and Crisis Management						
3 Info Exchange	3	3	3	3	3	2
23 Groups	3	1	1	2	1	1
24 Macroeprudential	2	3	2	1	2	2
25 Coordination	3	3	3	3	3	2
26 Crossborder	3	3	2	2	2	2
Conduct of Business, Intermediaries, and Fraud Prevention						
18 Intermediaries	1	2	2	2	3	2
19 Conduct of Business	1	1	1	1	2	2
21 Anti-Fraud	2	3	3	1	1	3
22 AML	3	3	3	1	1	2
Corporate Governance and Public Disclosure						
5 Suitability	2	3	2	2	3	2
7 Corporate Governance	3	3	2	2	1	1
8 Risk Management	2	3	2	1	1	2
20 Disclosure	1	1	2	2	1	3
Total	65	62	56	54	49	55

3 Observed 2 Largely Observed 1 Partially Observed 0 Not Observed

Source: KPMG 2015.

*Please note that although Korea was reviewed in 2014, the detailed scoring of their compliance was not published in the IMF report. We have included a section on ICP compliance within the geographical analysis of our regional updates, which includes an update on the findings of associated FSAP reviews. Korea is covered in those sections.

Global Insurance Capital Standard

There have been two key developments in the ICS journey during 2014 – the establishment of the ICS guiding principles and publication at the end of the year of a consultation document. The ICS is intended to be more risk sensitive,

and therefore more complex, than the Basic Capital Requirement (BCR) that was finalized in October 2014 as we describe later in this report, and the ICS will apply to around 50 IAIGs, not just the nine G-SIIs.

In September 2014, the IAIS released a set of high level principles that will guide the development of the ICS over the coming years (see following Table).

Table 4: ICS Guiding Principles

1	Consolidated group-wide standard with a globally comparable risk-based measure of capital adequacy for IAIGs and G-SIIs.
2	Main objectives are protection of policyholders and to contribute financial stability.
3	Become the foundation for the HLA for G-SIIs.
4	Reflects all material risks to which an IAIG is exposed.
5	Ensure comparability of outcomes across jurisdictions, providing increased mutual understanding and greater confidence among group-wide and host supervisors.
6	Promote sound risk management by IAIGs and G-SIIs.
7	Promote prudentially sound behavior while minimizing inappropriate procyclical behavior by supervisors and IAIGs.
8	Balance risk sensitivity against simplicity.
9	Remain transparent, particularly with regard to the disclosure of final results.
10	Capital requirement is based on an appropriate target criteria which underlies the calibration.

Source: IAIS Consultation on Risk Based Global Insurance Standard, 17 December 2014.

On 17 December 2014, the IAIS released a consultation document requesting feedback on its first draft proposal on the ICS. This initial proposal has effectively opened for discussion a variety of options that may be adopted to determine the ICS capital requirement. Key elements of the paper include liability valuations, qualifying capital resources and approaches to measuring risk. Even though the IAIS has now removed a firm deadline for implementation of the ICS, it has said it will continue to field test the proposals as outlined in the paper and to develop an interim standard based on that field testing. Over 1600 pages of comments were received in response to the consultation.

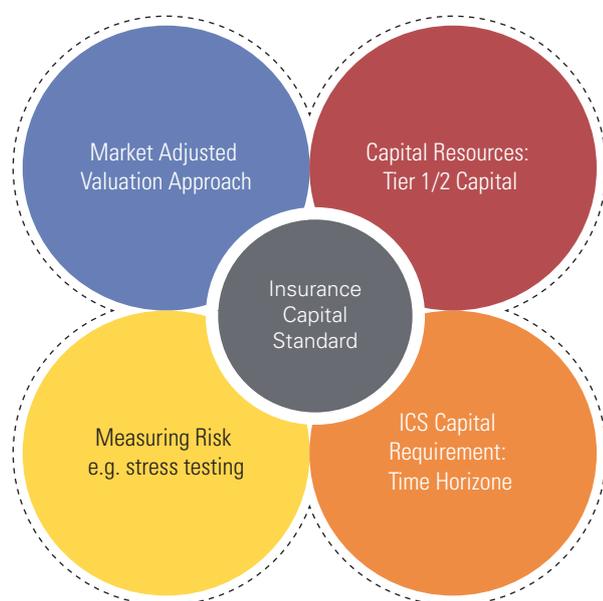
The consultation paper anticipates that the ICS will be implemented as a regulatory Prescribed Capital

Requirement (PCR)⁶ under which the supervisor will only intervene on capital adequacy grounds if the group's capital falls below the required level, although this assumption is queried in the consultation paper.

The IAIS is considering the addition of a backstop capital measure which will serve to supplement the ICS, but will be less risk sensitive and simpler than the ICS. This capital measure is expected to be very similar to the BCR and would broadly reflect the level of risk inherent within an insurance company based on its size. This measure may also be adopted as a notional floor to the ICS ensuring that a basic level of capital is always met (in essence, acting as an MCR).

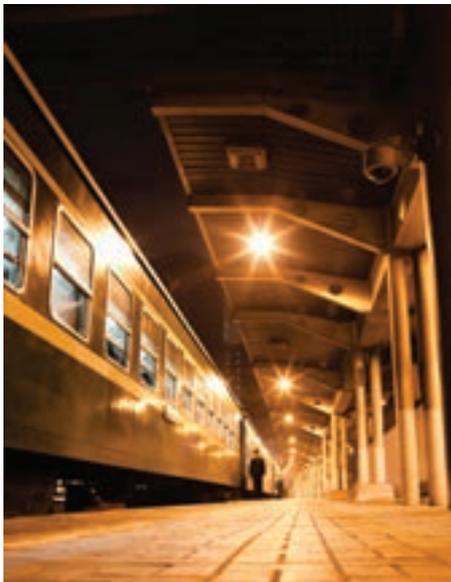
The diagram below illustrates the four key elements of the ICS that were addressed in the consultation paper:

Figure 3: Four key elements of the Insurance Capital Standard



Source: KPMG International 2015.

6. In the IAIS' core principles, the PCR is the higher regulatory intervention point, while a Minimum Capital Requirement (MCR) serves as the lower intervention level.



ICS valuation approach

The IAIS will require a consolidated group balance sheet as its starting point for the quantitative insurance capital standard. As such, this approach will necessitate a method for estimating insurance contract liabilities on a comparable basis across all jurisdictions in which the group has insurance operations.

Subsequent to the field testing exercise undertaken in 2014, the IAIS has decided that a market adjusted valuation approach will be the initial basis for developing the ICS standard methodology, similar to the one developed for the BCR calculation, because it increases comparability and risk sensitivity.⁷ At the insistence of the US regulators, a country's generally accepted accounting principles (GAAP) with regulatory adjustments will also be considered as an alternative valuation, which would be developed through a planned field testing exercise.

The purpose of this second option is to allow IAIGs to easily achieve a market adjusted valuation by making incremental and quantifiable adjustments to their local jurisdictional GAAP valuation. The adjustments required will be based on principles and will require reconciliation between a market adjusted and jurisdictional GAAP valuation approach. However, there may not always be a simple relationship between the two, particularly if the underlying valuation is based on significantly different methodologies. For life assurance there is the added complication that for financial statements drawn up under International Financial Reporting Standards (IFRS) and some GAAPs,

certain insurance contracts will have been reclassified as investment contracts for financial reporting, but will need to be included within the regulatory insurance provisions. Both these factors may be significant impediments to the adoption of a GAAP with adjustments approach.

A key issue hampering the development of a global valuation approach is that there is currently no single insurance accounting standard across jurisdictions. The International Accounting Standards Board (IASB) was expecting to complete the insurance contract standard by late 2015 or early 2016, but has recently delayed this and the timetable is currently unclear. This will mean the IAIS has to move forward with its proposals without this standard. At the moment, the market adjusted valuation approach being developed by the IAIS broadly reflects where the IAIS believes global developments on insurance accounting standards are heading. The IAIS has also highlighted its intention to engage with international bodies including the IASB, Financial Accounting Standards Board (FASB) and the International Actuarial Association (IAA) to encourage development of complementary standards. As such, it is expected that there will be refinement of the ICS valuation approach over time, particularly if valuation approaches across jurisdictions converge over time.

Margin Over Current Estimate

In its consultation document, the IAIS asked about the feasibility of introducing a margin over current estimate (MOCE) within the ICS as an additional component to the market adjusted liability valuation. However, the IAIS is yet to decide on a definition, treatment

7. A decision has been made to no longer field test an economic valuation approach because of the difficulty in gaining comparability.

(i.e. whether it will be included as part of liabilities or as part of capital resources) and calculation basis for the MOCE. The MOCE is normally a margin held in addition to the current estimate of insurance contract liabilities, largely for the purpose of covering the inherent uncertainty within those obligations. Incorporating a MOCE within the current estimate of liabilities would effectively result in the deferral of profit emergence into the future. In Solvency II, the margin is calculated by using conservative actuarial assumptions for liability valuations.

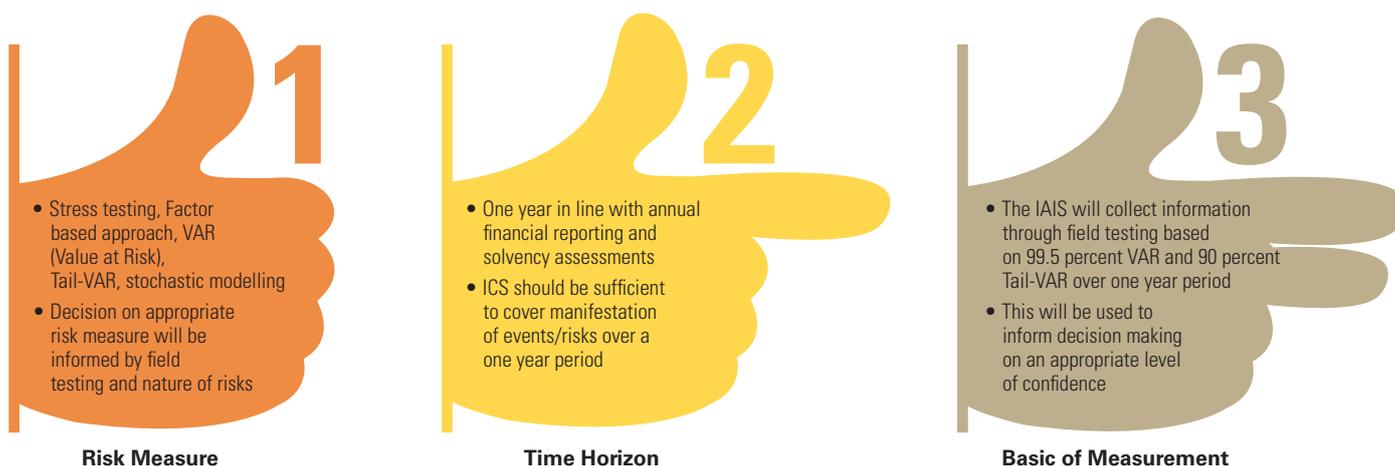
ICS confidence level

Another key aspect of the ICS capital requirement that remains unresolved and is likely to be the most contentious issue is the level of confidence that will be targeted. In this regard, jurisdictions across the world have adopted varying practices for regulatory purposes. The

IAIS has decided to calibrate the ICS to cover the capital required over a one year time horizon, but has not defined the target level. At this stage, the IAIS has indicated tentatively that, as part of the field testing exercises, it will collect data based on 99.5 percent Value at Risk (VaR) and 90 percent Tail-VaR (TVaR) over a one year time horizon. The purpose for collecting data at this high level of confidence is to allow flexibility when calibrating the ICS capital requirement. In particular, it will provide a better understanding of the tails of the loss distribution curve.

Further, depending on the approach taken to measure the risks and determine the capital requirement, the factors/stresses applied will need to reflect the level of confidence that is being targeted.

Figure 4: Key considerations of the ICS capital requirement



Source: KPMG International 2015.

Measuring Risk

The IAIS intends that the ICS capital calculation will build on the BCR methodology, but will be more risk sensitive and, therefore, more complex than the BCR. The IAIS proposal suggests that the ICS capital requirement will reflect the material risks illustrated in the Table below.

These risks broadly reflect the major risks that are encountered by insurance companies. Any risks that are not quantified as part of the ICS capital requirement, which is the main focus of the ICS currently, such as group risks as well as liquidity risks, are to

be addressed qualitatively within ComFrame.

The ICS capital requirement will be determined based on the impact to qualifying capital resources resulting from manifestations of the following risks:

Table 5: Risks and definitions

Categories of risk	Key risk	Scope/definition: Risk of adverse change in the value of qualifying capital resources due to
Insurance risk	Mortality risk	Unexpected changes in the level, trend or volatility of mortality rates
	Longevity risk	Unexpected changes in the level, trend or volatility of mortality rates
	Morbidity/disability risk	Unexpected changes in the level, trend or volatility of disability, sickness and morbidity rates
	Expense risk	Unexpected changes in liability cash flows due to the incidence of expenses incurred
	Lapse risk	Unexpected changes in the level or volatility of rates of policy lapses, terminations, renewals and surrenders
	Premium risk (non-life)	Unexpected changes in the timing, frequency and severity of future insured events (to the extent not already captured in morbidity or disability risk)
	Claim reserve/revision risk (non-life)	Unexpected changes in the expected future payments for claims (to the extent not already captured in morbidity or disability risk)
	Catastrophe risk	Unexpected changes in the occurrence of low frequency and high severity events
Market risk	Interest rate risk	Unexpected changes in the level or volatility of interest rates
	Equity risk	Unexpected changes in the level or volatility of market prices of equities
	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
	Spread risk	Unexpected changes in the level or volatility of credit spreads over the risk-free interest rate term structure
	Currency risk	Unexpected changes in the level or volatility of currency exchange rates
	Asset concentration risk	The lack of diversification in the asset portfolio
Credit risk		Unexpected counterparty default, including their inability or unwillingness to meet contractual obligations in a timely manner
Operational risk		Operational events including inadequate or failed internal processes, people and systems, or from external events. Operational risk includes legal risk, but excludes strategic and reputational risk

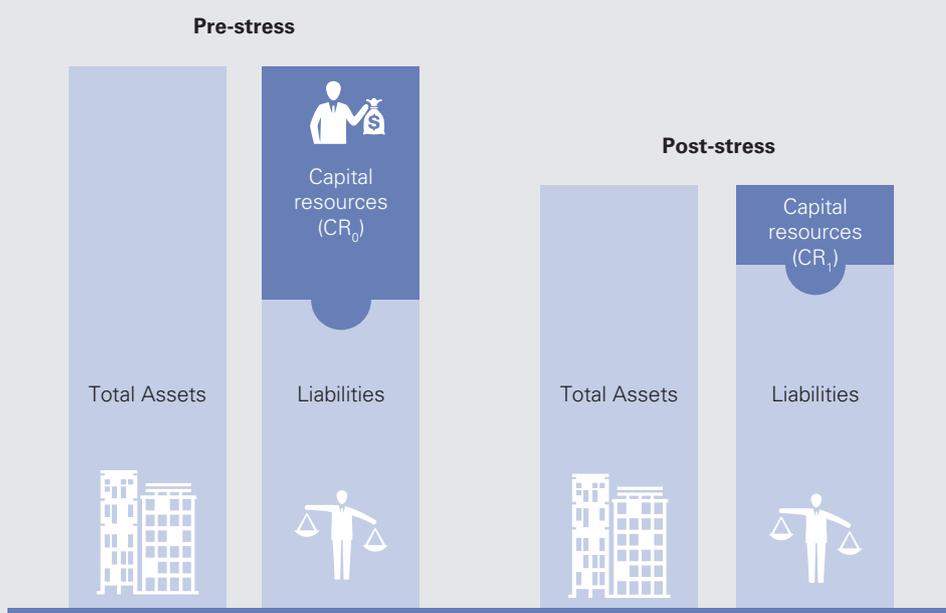
Source: IAIS Consultation Paper: Risk-based Global Insurance Standards, 17 December 2014.

The IAIS has considered various approaches to determining the ICS capital requirement that range in complexity. The methods under consideration include a factor based model, stress testing, stochastic modelling and structural modelling or some combination of these approaches.

- 1) The factor-based approach is similar to the approach decided for calculating the BCR, wherein specified charges are applied to particular exposures to determine the capital required. Most exposures would be balance sheet items.
- 2) Stress testing involves estimating the adverse impact on capital resources from stresses that are applied to balance sheet items. Each stress is intended to reflect the manifestation of a specific risk and the adverse impact on capital resources reflects the capital required. Figure 5 illustrates how a balance sheet might change and impact capital resources under a stressed scenario.
- 3) Stochastic modeling involves estimating the distribution of the change in capital resources over time through stochastic processes. A distribution is estimated for each type of risk being considered and this is aggregated across all risks to obtain the required distribution. Statistical tools can then be used to estimate the impact on capital resources at various confidence levels.
- 4) Structural modeling involves using causal relations specified using a combination of statistical data and qualitative causal assumptions. These assumptions often have implications that can be tested against observations.

// The IAIS has considered various approaches to determining the ICS capital requirement that range in complexity. The methods under consideration include a factor based model, stress testing, stochastic modelling and structural modelling or some combination of these approaches. //

Figure 5: Capital resources in stressed scenarios



Source: IAIS Consultation Paper: Risk-based Global Insurance Standards, 17 December 2014.

“The risk categories reflected in the proposed ICS capital requirement are not completely correlated and there is potential for diversification benefits to exist. Recognition of diversification benefits both within and between types of risks needs to be allowed for as part of the ICS capital requirement. Further, under stressed conditions, it is anticipated that the level of diversification between risks may decrease, and additional capital may be required to retain the same level of confidence.”

Bearing in mind that one approach may not be suitable for all risks, the methodology will be adjusted to the risk that is being quantified. The IAIS

has provided some guidance as to what approach might determine the charges associated with each of risk (see Table 6).

Table 6: IAIS approach to determine changes associated with risk

Risk/Sub-risk	Potential approach		
	Factor-based	Stress	Other
Insurance risks			
Mortality		●	
Longevity		●	
Morbidity/disability		●	
Lapse		●	
Expense Risk		●	
Premium	●		
Claim reserve/revision	●		
Catastrophe			●
Market risks			
Interest rate		●	
Equity		●	
Real estate		●	
Currency/FX		●	
Asset concentration	●		
Credit risk	●		
Operational risk	●		

Source: IAIS Consultation Paper: Risk-based Global Insurance Standards, 17 December 2014.

Allowance for Diversification

The risk categories reflected in the proposed ICS capital requirement are not completely correlated and there is potential for diversification benefits to exist. Recognition of diversification benefits both within and between types of risks needs to be allowed for as part of the ICS capital requirement. Further, under stressed conditions, it is anticipated that the level of diversification between risks may decrease, and additional capital may be required to retain the same level of confidence.

The IAIS has identified three basic approaches within the consultation document to address how diversification of risks might be calculated:

- 1) The first approach assumes that all risks are fully dependent and that all risk charges can be added together to get the capital requirement. This is a conservative approach that results in the highest capital requirement for a specific level of confidence.

2) The second approach assumes varying degrees of correlation between the risks and this is captured through an assumed correlation matrix. The risk charges are aggregated through a variance covariance matrix to determine the capital requirement.

3) It is anticipated that the third approach will involve modeling

the correlations and dependency structures between each of the various risk types (for example asset risks), including their risk drivers (for example inflation, interest rates and equities etc.). An assumption for the underlying distribution of the risks will be required and may also involve the use of copulas to help model the correlation structures and therefore allow for diversification.

The diagram below illustrates an assumed covariance matrix that can be used to aggregate the various risks and allow for diversification:

	Risk 1	Risk 2	Risk 3	Risk 4	Risk n
Risk 1	1	X_{12}	X_{13}	X_{14}	X_{1n}
Risk 2		1	X_{23}	X_{24}	X_{2n}
Risk 3			1	X_{34}	X_{3n}
Risk 4				1	X_{4n}
Risk n					1

Source: IAIS Consultation Paper: Risk-based Global Insurance Standards, 17 December 2014.

// The IAIS has separated Tier 1 capital into two categories to reflect the difference in quality between various Tier 1 financial instruments. Tier 1 items for which there is no limit include common/ordinary share capital and financial instruments for which there is a prescribed limit include non-cumulative perpetual preferred shares or certain hybrid instruments. //

Capital Resources

As the ICS capital requirement is likely to be set at the PCR level, all IAIGs will need to hold qualifying capital resources that are at least equal to their ICS capital requirement. The IAIS has decided that the capital resources must meet specific criteria in order to qualify as regulatory capital. In particular, the capital resources must provide for loss absorbency on a going concern, in adverse circumstances and during winding-up for the purposes of policyholder protection and financial stability.

Qualifying capital resources are segregated into the following four broad categories based on the quality of the capital, amongst other considerations.

- 1) Tier 1 financial instruments for which there is no limit
- 2) Tier 1 financial instruments for which there is a limit
- 3) Paid-Up Tier 2 financial instruments
- 4) Non-Paid-Up Tier 2 financial instruments.

The IAIS has separated Tier 1 capital into two categories to reflect the difference in quality between various Tier 1 financial instruments. Tier 1 items for which there is no limit include common/ordinary share capital and

financial instruments for which there is a prescribed limit include non-cumulative perpetual preferred shares or certain hybrid instruments. Tier 1 financial instruments that are in excess of a prescribed limit may be considered for inclusion in Tier 2. The purpose of this limit is to constrain the inclusion of certain financial instruments in Tier 1 capital resources for the purpose of calculating the ICS Ratio, which will be seen as a key measure. It is defined as total qualifying capital resources divided by the ICS required capital amount.

Tier 2 capital resources may also include some other forms of lower-quality financial instruments including subordinated debt. Capital instruments that would not count for either Tier include cumulative preference shares and short duration instruments. Recognition of non-paid up Tier 2 capital should be subject to approval from supervisors and it converting to an instrument or element eligible for classification in Tier 1 capital resources or paid-up Tier 2. There will also be regulatory adjustments applied to Tier 1 and Tier 2 capital.

Furthermore, specific balance sheet items are excluded from core capital. This includes items such as intangible assets, goodwill, deferred tax assets net of deferred tax liabilities, and direct investment in own assets.

Implications for IAIGs

Similar to the experience with Solvency II, the proposals currently are described at a very high level, making it difficult to determine what the group solvency position would look like on an ICS basis. Nevertheless, IAIGs should review the proposal carefully and respond on any significant points relevant to their business now, to allow this to be considered by the IAIS before the field-test basis is finalized. More importantly than this even, IAIGs, especially those groups that are not already participating in the field-testing exercises, should plan to participate in both the 2015 and 2016 field tests, if possible.

The evidence from the Solvency II quantitative impact studies (QIS) demonstrates that testing group requirements is significantly more onerous than testing requirements applied at a solo level, and the ICS field test will be further complicated by the fact that none of the solo entities within the group will be subject to its requirements. IAIGs should ensure that their plans for the field-test are sufficient to allow them to determine which parts of the group (if any) give rise to significant stresses, to enable them both to provide additional narrative feedback to the IAIS and to plan their own responses before the interim or final ICS goes live.

Regulation for Global Systemically Important Insurers

In November 2014, the FSB maintained its original list of nine G-SIIs that were identified in 2013. A decision to identify the status of reinsurers was postponed pending development of an appropriate methodology by the IAIS. It is expected that the G-SII assessment methodology will be further developed by November 2015 to address all insurance, reinsurance, and financial activities of global insurers.

The list of the G-SIIs identified as a result of the 2014 G-SII assessment exercise can be seen in Table 7. Classification as a G-SII results in additional supervisory measures being applied to the group, covering:

- Enhanced supervision,
- Effective resolution
- Higher loss absorbency (HLA) capacity.

Table 7: Current list of G-SII (FSB 2014 assessment)

• Allianz SE
• American International Group, Inc.
• Assicurazioni Generali S.p.A.
• Aviva Plc
• Axa S.A.
• MetLife, Inc.
• Ping An Insurance (Group) Company of China, Ltd.
• Prudential Financial, Inc.
• Prudential Plc

Source: FSB 2014 Update of List of Global Systemically Important Insurers, 6 November 2014.

Enhanced supervision generally means tailored regulation with greater supervisory resources being applied. This includes direct supervision of the holding company, development of a systemic risk management plan (SRMP) and enhanced liquidity planning and management, focusing on the group risk profile, to reduce both the probability and impact of its failure.

Effective resolution considers what specific measures would be required to ensure that the group could effectively be resolved without significant impact on the wider economy. Key elements involve the need to ensure that critical economic functions could continue if the group were to fail, resolvability assessments and the establishment of recovery and resolution plans (RRPs). Given the systemic nature of the group, crisis management groups (CMGs) will also be established to enhance the preparedness for, and facilitate the resolution of, a cross-border financial crisis affecting the group.

HLA capacity refers to additional capital requirements applied to the group which are intended to reduce the risk of failure, pass potential costs of failure back onto the groups themselves and ensure that supervisory authorities can intervene at an earlier stage if the group's financial position deteriorates or significant risks start to crystallize.

Enhanced supervision – Systemic Risk Management Plan

The SRMP is required to explain how the G-SII plans to manage and mitigate/reduce their systemic risks. The first step in this process is obviously understanding which elements of their business activities should be regarded as

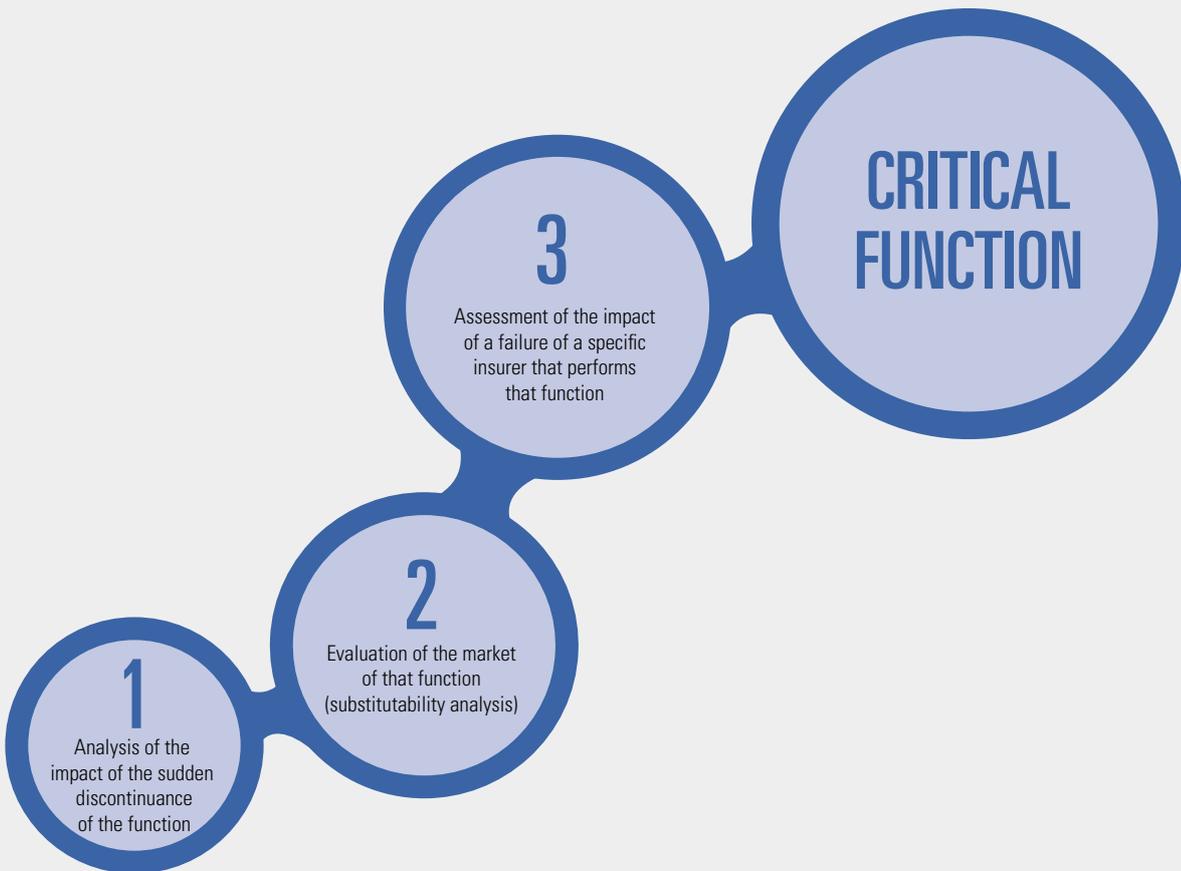
systemic, which may be different from the Non-Tradition Non-Insurance (NTNI) activities that were part of the G-SII classification process. This assessment requires the G-SII to identify their critical functions and services and to provide evidence that failure of their group would not lead to the disruption of these services nor any resulting contagion to the wider economy.

As the G-SIIs were required to submit their SRMP by the end of July 2014, much of the first half of 2014 was spent in developing these plans. Since then the discussion process with the group supervisor has been on-going, considering whether these address the risks appropriately.

Identification of critical functions

The FSB released in October 2014, a consultative document on guidance to help insurers identify critical functions. In this document, the

FSB described a three step process (which can be undertaken in any order) that involves the following key considerations:



Critical functions go far beyond than the NTNI activities of the group. The broad categories are shown in Figure 6 (although the paper also includes a long list of potential critical functions). These cover a significant range of activities that many insurers would regard as part of their core activities.

Critical economic functions provided by insurers are likely to differ across

jurisdictions in terms of their impact, which will make the substitutability component a key aspect of the analysis. Furthermore, the criticality of an economic function will depend on the circumstances of each individual insurance company, in terms of the size and market share of each company, amongst other things.

However, the FSB's starting point is that insurers may provide a wide range of critical economic functions, and the importance of the loss of these functions should be assessed in terms of the

impact, not just on the rest of the financial sector, but also on the real economy.

Examples of functions identified by the FSB that could be critical are shown in Figure 6.

Figure 6: Examples of critical functions identified by the FSB



Source: FSB's paper on Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Critical Shared Services consultation document, October 2014.

Insurance coverage vital for maintaining economic activity (such as employer liability insurance, professional indemnity insurance and shipping and airline insurance), insurance products that help individuals go about their daily lives (such as motor liability insurance, building and flood insurance and medical insurance) and policies providing financial security (such as annuities and savings funds) can all fall within the assessment of critical functions.

Insurance companies also play a significant role in investing and lending to the real economy and could play a greater role as countries look more to the private sector to finance major infrastructure projects. Failure of an insurer could therefore have adverse impacts on financial markets, resulting from large asset disposals and a lack of new investment or lending. Similar market disruption could arise if the

insurer invested heavily in derivatives and other securities.

Interestingly, given the failure yet to classify any reinsurer as a G-SII, failure of a major reinsurance arrangement is identified as a critical function, as it has the potential to cause significant disruption through associated impacts on insurers and their activities.

By identifying critical insurance functions that can have adverse economic impacts, it is evident that the FSB is breaking away from the emphasis placed solely on NTNI activities. Arguably, this could call into question the emphasis placed on NTNI activities in terms of determining the systemic importance of insurers, and therefore the applicable capital requirements. We expect some of this debate to be reflected in the revised identification methodology for G-SIIs to be published in 2015.

/// The IAIS and FSB have continued work to develop RRP frameworks which will apply to systemic insurers. The intention is that this will not only apply to the G-SIIs, but ultimately also to those insurers that are identified as systemically important at a domestic level. The underlying intention is that resolution authorities should be able to resolve these insurers without exposing taxpayers to loss and to minimize economic disruption. ///

Effective resolution – Recovery and Resolution Plans

The IAIS and FSB have continued work to develop RRP frameworks which will apply to systemic insurers. The intention is that this will not only apply to the G-SIIs, but ultimately also to those insurers that are identified as systemically important at a domestic level. The underlying intention is that resolution authorities should be able to resolve these insurers without exposing taxpayers to loss and to minimize economic disruption.

These groups will be required to have in place a robust governance structure to support their RRP. This includes responsibilities allocated to and in respect of all business units, identifying all senior executives responsible for developing and maintaining the RRP and integration of the RRP into the overall governance processes.

The first RRP reports were due to be submitted by 31 December 2014.

Basic Capital Requirement (BCR)

A key milestone on the path to developing a global ICS was achieved in November 2014 when the G20 Brisbane Summit approved the BCR proposal developed by the IAIS.

The final proposal was a year in the making and the outcome of two public consultation periods and a field testing exercise which included participation from several insurance groups, including all nine G-SIIs. The BCR has been developed in line with its key guiding principles (see Figure 7) established at the outset by the IAIS. Measured against these principles and, given the short timeframe for development, the IAIS rightly view the BCR as a successful milestone toward the development of the ICS.

Confidential reporting of the BCR will begin in 2015, the results of which may be used by the IAIS to further refine the calculation methodology.

Figure 7: Guiding principles of BCR development



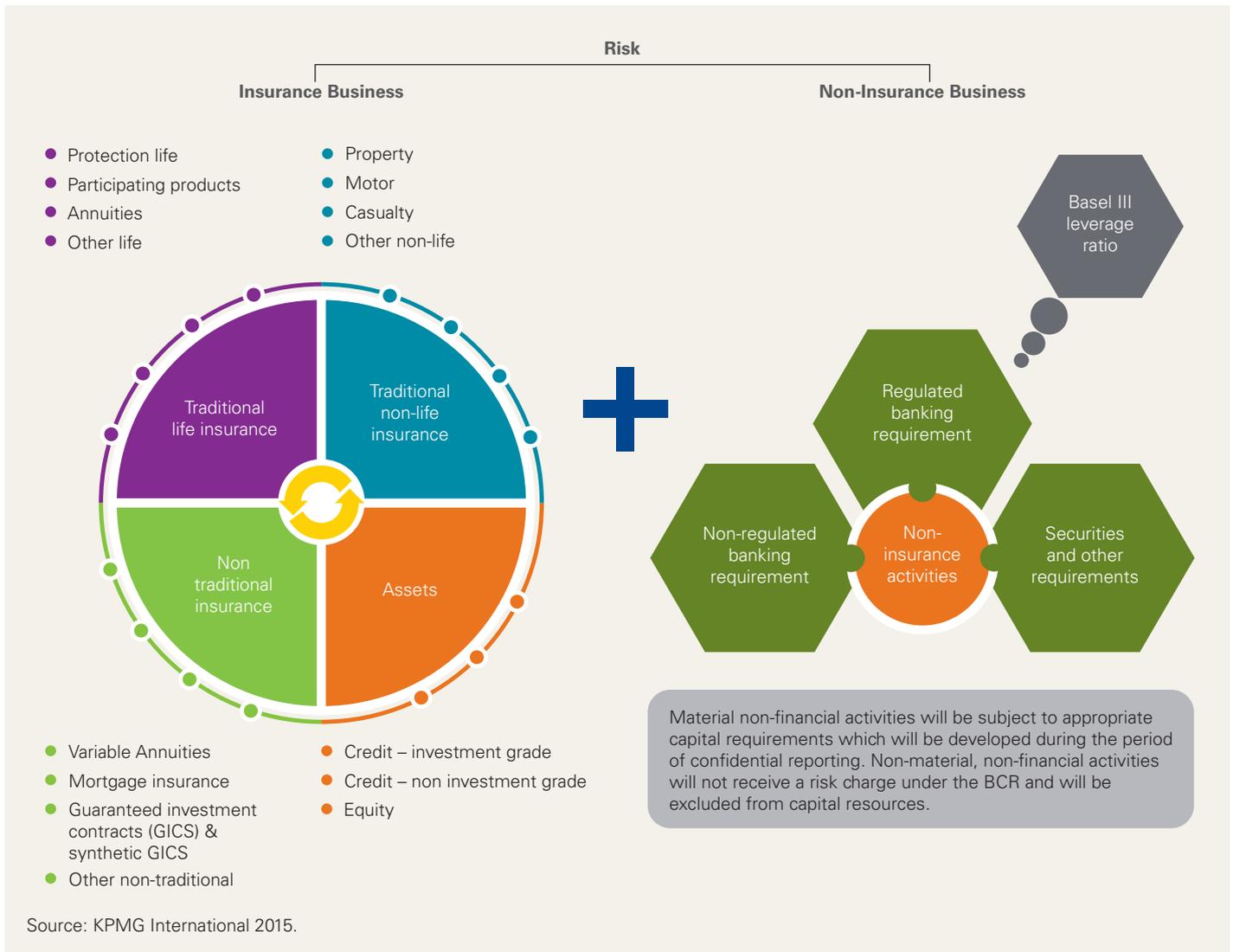
Source: IAIS Basic Capital Requirements for Global Systemically Important Insurers, 23 October 2014.

Required Capital

The BCR capital charge can be segregated by business activity. More specifically, this can be broken down into an insurance capital component based on the insurance businesses the group operates, an asset charge

component based on the type of asset holdings and a charge for all non-insurance financial and non-financial activities. Figure 8 illustrates the components of the BCR.

Figure 8: Components of the basic capital requirement



/// The BCR for insurance and asset risks are calculated through a factor based model designed to capture the main categories of risk that impact G-SIIs. The model consists of 15 factors or charges that correspond to various products which are applied to exposures to obtain the BCR. ///

The BCR for insurance and asset risks are calculated through a factor based model designed to capture the main categories of risk that impact G-SIIs. The model consists of 15 factors or charges that correspond to various products which are applied to exposures to obtain the BCR. The size of the factors are currently prescribed by the

IAIS and were calibrated through the field-testing exercise conducted in 2014. (These factors are provided in the Table below). For most products, the regulatory balance sheet would provide the information required to calculate both the required capital and qualifying capital (see Table 8).

Table 8: Required capital and qualifying capital

BCR segment	Proxy measure for risk exposure	Factor	Factor value
Traditional Life (TL)			
Protection life	Net Amount At Risk	a ₁	0.06%
Participating products	Net Current Estimate	a ₂	0.6%
Annuities	Net Current Estimate	a ₃	1.2%
Other life	Net Current Estimate	a ₄	0.6%
Traditional Non-life (TNL)			
Property	Premium Measure	b ₁	6.3%
Motor	Net Current Estimate	b ₂	6.3%
Casualty	Net Current Estimate	b ₃	11.3%
Other non-life	Net Current Estimate	b ₄	7.5%
Non-Traditional (NT)			
Variable annuities	Notional Value	c ₁	1.2%
Mortgage insurance	Risk in Force	c ₂	4.0%
GICS & Synthetic GICS	Notional Value	c ₃	1.1%
Other non-traditional	Net Current Estimate	c ₄	1.3%
Assets (A)			
Credit – investment grade	Fair Value	d ₁	0.7%
Credit – non investment grade	Fair Value	d ₂	1.8%
Equity, real estate & non-credit investment assets	Fair Value	d ₃	8.4%

Source: IAIS Paper: Basic Capital Requirements for Global Systemically Important Insurers 23 October 2014.

For most insurance products, the regulatory value of the liabilities is used as the exposure measure and is determined by the net current estimate of liabilities (CEL) valuation approach. The IAIS details a market adjustment methodology to determine the value of the liabilities and prescribes a discount rate that is to be used to ensure consistency across jurisdictions. For assets, the exposure is the value of the assets and is measured on a fair value basis.

Market adjusted methodology

A market adjusted methodology is adopted to calculate the current estimate of liabilities (CEL). The CEL represents the present value of the mean of the distribution of future cash flows and has the following characteristics:

- Probability weighted average of the present value of future cash flows associated with insurance contracts using the IAIS prescribed term structure of interest rates. Margins are not included as part of the CEL and the projected cash flows should include the following:
 - Benefit payments
 - All expenses including investment expenses, administration expenses, acquisition expenses and other expenses
 - Premiums received
 - All other cash flows.
- The CEL should be based on up to date and realistic assumptions to project all future cash flows for the life of each policy, with the projection period determined by reference to the contractual boundaries of each policy.
- Embedded options and guarantees (such as minimum investment returns, surrender options or other policyholder options) should be included in the cash flows.
- Policy behavior should also be taken into account, particularly with regard to changes to the amount, timing and nature of benefits.
- Management actions can be taken into account to the extent that they can reasonably be expected to be carried out in the future.

Qualifying Capital Resources

The qualifying capital resources are determined on a consolidated group-wide basis and are classified as either core or additional capital. Core capital is defined as those financial instruments having the following characteristics:

- No fixed maturity, not retractable by the holder and not redeemable within the first 5 years
- Fully paid up with no fixed servicing costs; distribution can be cancelled without risk of default; non-cumulative
- Free from charges, claims or other hindrances and do not include a right to compulsory payments
- Requires that redemption be subject to review/ approval from the supervisor.

Additional capital is defined as having the following characteristics

- Initial maturity of at least 5 years, with the following conditions
 - Notional amount of instrument amortized on a straight line basis over the final 5 years to maturity

- Requirement for G-SII to suspend redemption if it is, or would be, in breach of its capital requirements if the instrument is/were to be redeemed

- Redemption is subject to review by the supervisor
- Holder has no right to accelerate repayment of future coupon or principle payments except in certain bankruptcy.

Furthermore, specific balance sheet items are excluded from core capital, including items such as goodwill, intangible assets, deferred tax assets net of deferred tax liabilities, cross holdings, direct investment in own assets and other items. The terms core capital and additional capital may be amended in future to tie in with the new tiered capital definitions used within the ICS consultation document.

A key measure of the BCR is the BCR Ratio, determined as total qualifying capital resources divided by required capital. For the purposes of determining this ratio, qualifying additional capital resources cannot exceed 50 percent of required capital.

Higher Loss Absorbency (HLA)

Having finalized the BCR approach, the IAIS will refocus its efforts on developing the methodology to calculate the HLA that will be applied to all G-SIIs. Upon implementation of ComFrame and the ICS, all G-SIIs will be required to hold capital in excess of the ICS plus the HLA. The impact of the decision to delay a final ICS beyond 2019 will impact the HLA which needs to be in place by that date. The IAIS has not yet provided guidance in this area.



The IAIS is concerned about the systemic risk posed by G-SIIs, particularly because of the rising macro-financial linkages between insurance activities and the financial sector. As such, the IAIS' primary objective is to require G-SIIs to reduce or ring-fence their NTNI activities.

The HLA capital requirement is primarily targeted at the NTNI aspects of their

business. It is anticipated that the HLA capital requirements will need to be met by core capital that is able to cover losses at all times.

In September 2014, the IAIS released a set of principles that will guide the development of the HLA (see Table 9).

Table 9: HLA Principles

No.	HLA Principles
1	Outcomes should be comparable across jurisdictions.
2	The HLA should reflect the drivers of the assessment of G-SII status.
3	The HLA should internalize costs of failure or distress of a G-SII that would otherwise result in costs to the financial system.
4	HLA should remain valid in a wide variety of economic conditions.
5	The HLA assumes that G-SIIs are going concerns.
6	The HLA capital requirement is to be met by the highest quality capital.
7	The design of the HLA needs to be pragmatic and practical, balancing granularity and simplicity.
8	The HLA should be consistent and over time applicable for insurance and non-insurance entities.
9	The level of transparency, particularly with regard to the final results provided and the use of public data, should be optimized.
10	The HLA will be refined in light of experience and data gathered by the IAIS in the course of Field Testing exercise.

Source: IAIS, Higher Loss Absorbency Principles, 22 September 2014.

Implications for G-SIIs

- The valuation basis adopted for all assets is fair value and for insurance liabilities is the current estimate of liabilities. There is currently no uniform valuation approach for assets and liabilities for either regulatory or accounting purposes, so insurers in some markets will need to develop a valuation methodology based on these prescribed requirements. In light of IFRS and the move toward global insurance liability valuation standards, it would make sense to adopt a consistent valuation approach where possible.
- It remains unclear what the target level of confidence the BCR is being set at, however, it appears to be in the range of 85–90 percent VaR. It is unlikely that this will cause much concern for G-SIIs, as most would already hold group capital levels above this amount. This was confirmed by the field-testing exercise conducted in 2014.
- As part of the field-testing conducted by the IAIS, 8 G-SII participants reported total qualifying capital resources of 427 percent of the proposed BCR on average and core qualifying capital resources of 376 percent on average. For all 34 volunteers that participated in the field-testing exercise, these figures are 404 percent and 355 percent respectively.⁸ This indicates that most insurers are well capitalized relative to the level of capital implied by the BCR. However, if the target level of confidence were to be increased (upon developing the ICS and the HLA), this may result in political tension across various jurisdictions.

Figure 9: Allocation of capital charge



Source: IAIS Basic Capital Requirements for Global Systemically Important Insurers, 23 October 2014.

- Looking forward, there still remains significant uncertainty regarding the practical application of the BCR and local jurisdictional requirements.
- The level of sophistication adopted in developing the BCR was carefully balanced against its purpose of maintaining simplicity and comparability across jurisdictions. As such, due to its simplicity, the BCR does not appear to be sensitive to various risk types but rather acts as a gauge of the 'level of risk' to determine capital levels.

Table 10: Risk Addressed within the BCR Framework

Asset risks	✓
Liability risks	✓
Operational risks	✗
Asset/Liability matching	✗
Allowance for Diversification	✗
Insurance risks/claims risk	✗
Interest rate sensitivity/risk	✗
Liquidity risk	✗

8. IAIS Basic Capital Requirements for Global Systemically Important Insurers, 23 October 2014

KEY INSIGHTS AND PERSPECTIVES FROM LEADING REGULATORS AND CROs ON GLOBAL DEVELOPMENTS

This year as part of our report on *Evolving Insurance Regulation*, KPMG interviewed leading regulators and insurance company CROs from around the world regarding their views on developments towards a global capital standard, policyholder protection levels, group-wide supervision and colleges, systemic risk and recovery and resolution plans, and the future of global standards, including cross-sectoral consistency in regulatory requirements.

Key findings

Both industry practitioners and regulators saw value in greater international consistency and harmonization of insurance requirements, but raised concerns as to whether this could be achieved in practice. They also expressed continued strong support for supervisory colleges, ongoing cooperation and engagement by supervisors, and a desire for greater IAIS focus on supervisory activities going forward.

The panel of regulators were very aware that the implementation of the ICS still requires much more understanding and debate amongst supervisors and industry, particularly regarding how global standards may coexist alongside local requirements. All participants agreed more dialogue is required as to whether the ICS should be a framework in which different regulators work within the broad parameters set or whether these new standards will require changes to local solvency requirements.

FROM INDUSTRY, WE SPOKE TO REPRESENTATIVES OF SOME OF THE LARGEST GLOBAL INSURANCE GROUPS, NAMELY:



Hugh Graham
Chief Risk Officer
AIA Group



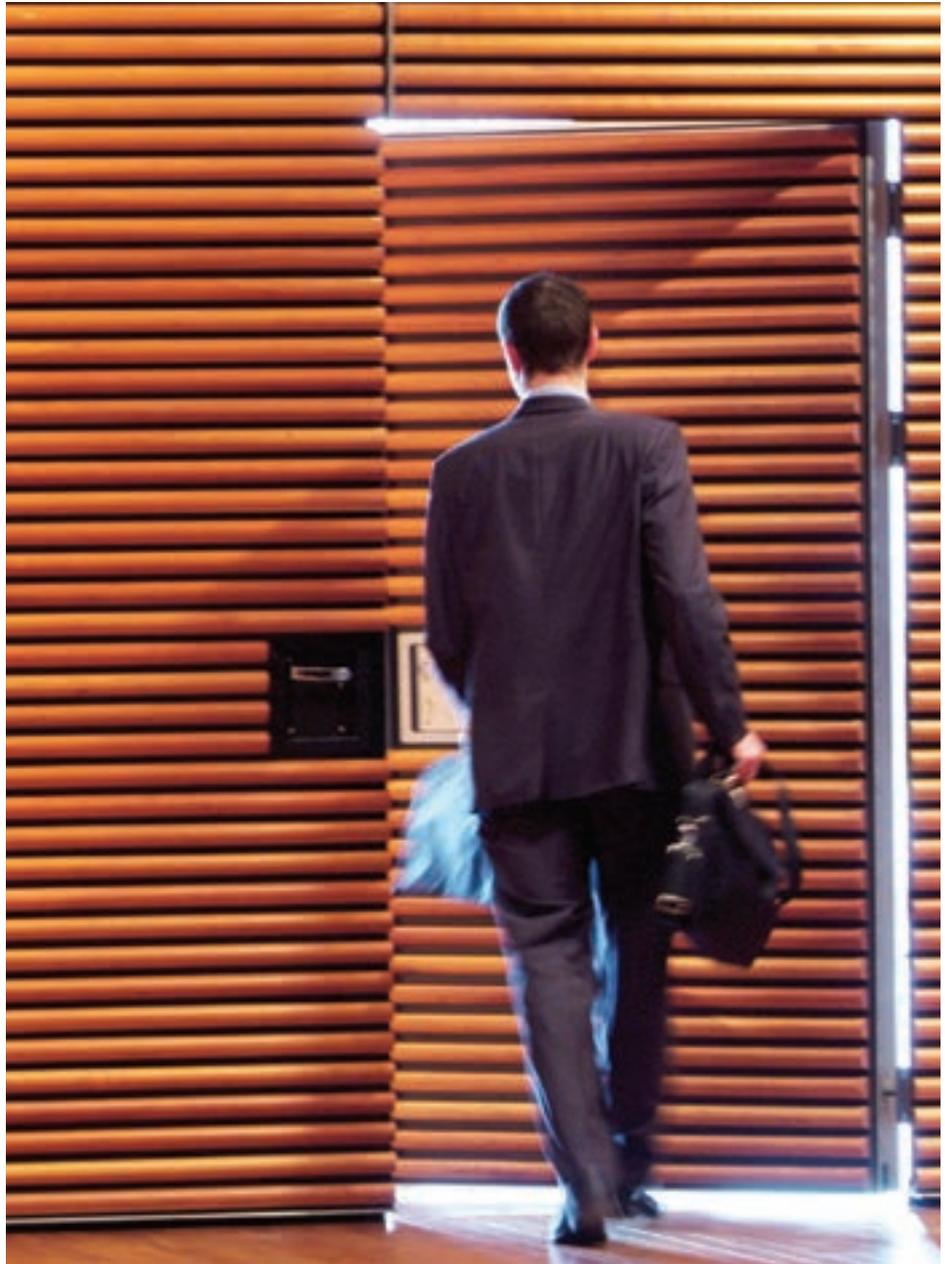
Sue Kean
Group CRO
Old Mutual Group



Axel Lehmann
Group CRO
Zurich Insurance Group

The CROs particularly expressed their desire for:

- More dialogue on future proposals of the new capital standards currently being developed
- Greater consistency with international accounting standards, especially regarding valuation and
- More open dialogue and debate on issues such as the appropriate level of policyholder protection for the new ICS.



Vision

One of our key questions asked what the 'vision' for ComFrame should be. We asked whether ComFrame should operate in a similar manner to a Basel Accord framework, whereby existing local requirements would be amended to adopt the new international standard, or whether ComFrame should be a high-level framework which jurisdictions would align themselves towards in order to reach similar outcomes, without necessarily changing existing solvency requirements.



Stan Talbi
Group CRO
MetLife

FROM THE REGULATORY COMMUNITY, WE SOUGHT PERSPECTIVES FROM BOTH SIDES OF THE ATLANTIC, NAMELY:



Gabriel Bernadino,
Chair, EIOPA



Kevin M. McCarty,
Insurance Commissioner,
State of Florida

Several CROs saw benefits in having an ICS that could be applied globally, with Axel Lehmann citing a number of advantages, such as:

- Help overcome fragmentation amongst supervisory jurisdictions
- Achieve better consistency, especially in reference to accounting standards and
- Assist regulators, as well as insurance firms, to have a common language, particularly as many stakeholders mean the same thing but often speak with a differently vocabulary.

It makes sense for the insurance industry to have a minimum capital standard against which all participants can be benchmarked. This should encourage a level playing field, promote a certain level of protection for policyholders and thus reduce in systemic risk.

–Hugh Graham,
AIA Group

Hugh Graham (HG) commented: ‘It makes sense for the insurance industry to have a minimum capital standard against which all participants can be benchmarked. This should encourage a level playing field, promote a certain level of protection for policyholders and thus reduce systemic risk.’

However, HG also cautioned that the ‘standard should be a benchmark and not a binding constraint; ultimately individual regulators should set standard that suit their jurisdictions’, while **Stan Talbi (ST)** reflected the views of many of his peers by saying: ‘In the push for a common international framework, all the supervisors have dug their heels in and are saying they won’t change their regime, so it looks like the ICS will be another reporting requirement’. Similar sentiments were echoed by **Axel Lehmann (AL)**: ‘the insurance capital standard should not come over the top of existing requirements – so should be a framework that is flexible enough and provides a transition plan, providing a consistent framework that can be applied locally but not added to existing requirements... In practical terms, this could mean having an ICS as a measure, but using the Swiss Solvency Test as the actual regulatory requirements’.

Sue Kean (SK) observed that it was not clear what extra protection a global standard would bring and voiced another key concern of CROs saying: ‘No one wants an environment where businesses are being piled up with multiple measures, for example, accounting and from a risk management perspective where such differences can add to pricing issues and costs become additive’. She also raised specific concerns about the impact on developing countries.

Kevin McCarty (KM) acknowledged that there was a level of confusion as to ComFrame. He elaborated, ‘It is unfortunate that a project as important as ComFrame, including the BCR and especially the ICS, has struggled with a lack of clarity as to the meaning and intent

of important concepts and foundational principles, e.g. comparability, group, etc. In the push to gain acceptance for ComFrame, the strategy seemed to be allowing ComFrame to be “All things to all people.” Parties have been interpreting these ideas in different fashions, and it has made the development process more complicated than I think it could have been.

My thoughts all along are that ComFrame and its attendant tools and principles should be a framework that allows for a higher degree of supervisory transparency and clarity for those complex financial organizations that are assuming risks across the globe. I never envisioned, nor could I be supportive of, a single prescriptive solvency regime for all insurers but rather a framework that would allow supervisors, and other stakeholders, to understand risk in an insurer based on their existing or enhanced jurisdictional requirements. If enhancements are needed, such as the work we have been doing (at the NAIC and in conjunction with our colleagues at the FIO and FRB), then it should be done within the jurisdictional framework.’

These views were similar to CROs with AL saying, ‘For now, it is important to find the common middle ground, such as in regards to valuation and capital standards between countries to help foster a global framework. Such an outcome would be better than what we have now.’

In contrast to the general views expressed, **Gabriel Bernardino (GB)** was much more positive in that he thought ‘the ultimate goal should be that Comframe, including the International Capital Standard (ICS), becomes an international minimum standard that national or regional standards should comply with. The ultimate goal should be to develop a single ICS based on a common methodology by which we can achieve substantially the same capital requirements across jurisdictions, avoiding regulatory and capital arbitrage and improving the effectiveness of the supervision of internationally active

insurance groups. Going forward, all jurisdictions should be open to make adjustments to their systems in order to ensure convergence with the ICS. Insurance groups should be subject to only one group capital regime.'

Policyholder protection

For a number of years, it has been difficult for stakeholders to engage in the debate regarding the appropriate level of capital for ComFrame and, correspondingly, policyholder protection, in the absence of a clear view from the IAIS.

The CROs raised a number of key concerns on calibration, including uncertainty concerning different methods, compensation schemes ('the biggest area missing in all of the global discussions, conduct risk' (SK)) and the issue of Treating Customers Fairly (TCF), reserving policies and 'how you could wind down an insurance company in an orderly fashion' (AL). Some CROs thought it was 'too early to have a view on calibration' (ST) and that 'the focus should be on activities rather than the enterprise itself in setting additional capital' while HG acknowledged that 'there are arguments for and against different levels of capital'. AL believes that 'policyholder protection should be a key consideration', suggesting that 'regulatory capital should always be a minimum and something around investment grade is likely to be the right level', while ST raised the risk that, 'as there are not enough firms to properly calibrate, the ICS may result in higher risk charges than should otherwise be the case'.

From a regulatory perspective, KM acknowledged the potential controversy and added that 'within acceptable parameters, the key role of the supervisor is to ensure that the insurance promise made is a promise good. If there is an issue with a particular insurer, there needs to be a resolution framework, such as the US network of guaranty funds, in place that allows for the workout of the issue while

maintaining the sanctity of the insurance promise made in the contract. I also think you will find that this is a common view among solvency regulators operating within a functional regulatory framework. If, on the other hand I were part of an integrated financial regulator, I might be more persuaded toward an "acceptable" level of risk to be borne by policyholders in the desire for financial stability in the large. How much risk and so forth is a question that seems to me to be dependent on the structure of these organizations and their role within a particular economic jurisdiction. Within ComFrame, my obvious bias would be toward a policyholder protection focus at least as robust as that which we currently provide'.

GB stated that 'a risk-based prudential standard needs to have clear and transparent target calibration criteria for capital requirements. Furthermore, other high-level elements need to be appropriately reflected in the ICS development: risk sensitive valuation consistent with the information provided by the financial markets; total balance sheet approach; explicit recognition of risk diversification; consideration in capital requirements of all the material risks to which the group is exposed; and, allowance for the use of different levels of sophistication (from the basic requirements up to internal models).'

Achieving global and especially US cooperation

It has been widely acknowledged that progress towards an international capital standard by the IAIS has been difficult given the bespoke nature of insurance supervision globally and the perceived strength of existing regulatory requirements in many jurisdictions, notably the US. These sentiments were reflected by HG who commented that 'some regulators may feel that a single capital standard is not warranted: solvency supervision at the legal entity level has worked well for them'.



Within acceptable parameters, the key role of the supervisor is to ensure that the insurance promise made is a promise good. //

– Kevin M. McCarty,
Insurance Commissioner,
State of Florida

/// The clarification to the Collins amendment to Dodd Frank would now require the Fed to accept each company's accounting standard if GAAP is not used. This means a statutory accounting basis for mutual companies regulated by the Fed by virtue of their ownership of Savings and Loans. ///

– **Stan Talbi,**
MetLife

The complexity of issues involving the US was underscored by ST who noted that: *'To get the US on board, you'd have to have a capital regime that is US statutory accounting or US GAAP based. However, a US statutory based system is difficult for other firms internationally and so it would likely have to be GAAP-based or provide a conversion mechanism to GAAP. The clarification to the Collins amendment to Dodd-Frank would now require the Fed to accept each company's accounting standard if GAAP is not used. This means a statutory accounting basis for mutual companies regulated by the Fed by virtue of their ownership of Savings and Loans.'*

Another difficulty highlighted by the CROs in achieving a global framework is that *'the underlying balance sheets are different. You end up with confusion rather than convergence – given underlying accounting bases are so different. It presumes the underlying is similar, which it isn't'* (SK). Further, *'a market consistent basis is not an approach that US firms like due to the volatility – i.e. being market-based – it doesn't make sense to show that volatility given liabilities are relatively illiquid and relatively long-term'* (ST). Meanwhile, AL suggested two ways to address such issues: *'Firstly, everyone needs to be on the same boat regarding the overall discussion, and secondly, we need to move along and continue to make progress and those who want to be involved can be involved. Maybe different trains and different speeds are required'*.

GB stressed the importance of regional cooperation. *'I believe that the development of an ICS in the insurance sector is necessary and achievable. All jurisdictions around the globe, coming from more mature markets like the EU and the US, but also from emerging markets in Asia, Latin America and Africa, need to work together to ensure improved convergence over time. The setting up of an ICS is a fundamental objective for financial stability, as stated by the Financial Stability Board.'* GB also recognized the

special efforts being made between the EU and US supervisors. *'I would like to mention the important contribution of the EU-US Insurance Project to an increased mutual understanding and enhanced cooperation between the EU and the US on insurance regulation and supervision. This project is delivering concrete products and outcomes, proving that convergence is possible over time.'*

KM provided the US regulatory perspective: *'Do I think a standard, global risk-based capital regime is achievable? Maybe at some point in the future, but I think the US's healthy scepticism of such a standard is likely fairly common in other well-functioning jurisdictions. As a result, I don't think there will be a universal appetite to adopt a global capital standard yet. We will all have to see what comes out of the current IAIS work and how well it suits our markets or improves our supervisory efforts. To suggest anything else is, I think, overly aspirational. I do think, though, that the NAIC should consider a group capital standard for IAIGs perhaps including a confidence level, which could provide a bridge across the regions and different capital standards. I would note that state regulators are working along several lines, including close collaboration with our Federal colleagues, to develop a US group capital framework.'*

Recovery and Resolution Plans for Domestic Systemically Important Insurers

The FSB's *Key Attributes for Global Systemically Important Financial Institutions* G-SIFIs has raised the need for recovery and resolution plans and the issue of whether analysis pertaining to 'recovery' elements should nonetheless be a standard risk management requirement for insurers.

The CROs were uniformly of the view that *'from a risk management perspective,*

knowing what your options are as to cash and capital in the event of a crisis is useful and all companies should have this' (ST) and that techniques such as reverse stress testing were useful, especially as 'Directors of an insurance company ... are very interested in how the institution will protect itself or ultimately realize its obligations to policyholders in a variety of stressed conditions' (HG).

However, many expressed the view that while 'recovery analysis elements do seem quite helpful ... as is often the case, a lot of nervousness from firms is that certain things will get mis-used by supervisors' (SK). AL further cautioned that 'there should not be form over substance', stressing that 'firms always find a way to manage a wind down without an RRP', while ST observed that 'these RRP's are very specific to legal entities rather than taking a wider risk view'. SK further raised the point that 'some of the reverse stress tests are geared up to 1 year frameworks, which is fine for regulators and examining the immediate impact on the balance sheet, but not for shareholders who take a longer view. Management also need a longer time horizon to properly undertake management actions'. ST also observed that 'an insurer can take 20-40 years to wind down. This is a long time. The requirements for resolution should reflect that significant fact'.

Similar views were echoed by KM who said 'the definition of systemic risk should remain narrowly focused on avoiding "economic havoc" and should not be expanded to include market disruption. A failure of a large company might require supervisory intervention, but that does not mean it is systemically risky. We need to remain conscious of the cost of regulation, such as the requirement for resolution plans, since those costs are ultimately borne by the policyholders'.

GB noted that 'the key attributes are aimed very specifically at the G-SIIs rather than the broader population of insurance groups, nevertheless there are aspects

of formalized Recovery and Resolution planning that have broader applicability. "Recovery" planning would undoubtedly be an important element in good risk management whereby all undertakings would have a clearer understanding of the potential options available to them to deal with a stressed situation. The need to engage in this activity and its expected sophistication should be viewed, as always, in terms of proportionality – simpler business models do not raise the same issues as more complex business models.'

Group-wide supervision and colleges

The CROs were generally supportive of the supervisory college process believing 'it is helpful to get a common view of the group amongst our supervisors' (AL) and 'the more engagement the better' (HG). However, it was noted that while some groups have had good experiences, others have not – even to the extent that there have been 'variations within a country' (SK). ST stated that 'If the supervisors can get comfortable with the overall risk profile and capital position of the group, I'd like to see it result in more capital fungibility between legal entities and allow capital to flow more freely where it may not be needed in its current location but may currently be restricted from moving freely'.

Other CROs also expressed the view that differences between local and group supervisors needed to be clarified – 'for example, what powers do supervisors have within the college? In essence, the group supervisors have responsibilities and powers in relation to group supervision and the others are responsible for their own local entities. More clarity is therefore required on how these colleges should function and perform and of course, MMoUs are needed'. A lot of firms are preparing for colleges now. This is resulting in more senior resources being used to present at, and more material being prepared for, the colleges by firms. There are also some multiple information





requirements from supervisors going to local entities, which becomes inefficient and costly. So, overall, it's an important role and, equally important as we move into ComFrame and a level playing field, it should not just be about capital, but how the information is used to better achieve supervisory outcomes (SK). Similarly, AL noted that 'collaboration, trust and integration is something for the supervisors to address'.

From a regulatory perspective, GB believed that 'colleges of supervisors have made good progress in the last years and have been fundamental to increase the exchange of information between supervisors worldwide, moving towards a more common analysis and measurement of risks. This evolution will benefit from the development of the ICS, which will create a common language of risks, capital requirements and capital resources. KM shared similar views that 'supervisory colleges have become more effective as the process has grown and matured'.

Conglomerate supervision

In terms of conglomerate supervision, we asked our respondents whether they could see different sectors coming together to apply a common approach to capital and risk requirements or whether they would continue to have their own respective requirements going forward.

The CROs were reasonably consistent in their view that 'financial services sectors are quite different to one another' (AL) and that 'there should not be a common approach because the risk factors are very different. Maturity transformation with banking is quite different. Insurers don't have the same liquidity issues. There is some commonality between banks and insurers, such as stress tests and even liquidity in the broader sense, but the liability profile for insurers is very different for insurance policyholders – so some commonality in approach makes sense at

a broad level but the approach to capital should be different' (ST).

Such sentiments were echoed by HG who noted that while 'it is very tempting to see some form of economic capital model as a universal panacea which can be applied to any business in any market ... these models are complex, potentially volatile and cannot necessarily capture all the risks and potential benefits associated with a business. In the case of conglomerates you need to think about the risk profiles particular to different types of financial services when evaluating their riskiness. For example, the liquidity risk profile for banks and insurers is completely different: where a bank needs to keep its balance sheet fairly liquid, an insurance company can take more liquidity risk – how do you present that robustly in a single model?'

SK also suggested that 'Sub-colleges, or sub-groups for some sectors might be a better approach than just one group-wide conglomerate approach. However, I recognize that local supervisors are wanting to get a group-wide ORSA, though I think the banking impact is questionable. For example, the underlying accounting is so different between banking and insurance, and the approach to capital is different between the sectors, including the underlying asset valuation basis. As a further illustration, accounting for banks' bad debts and impairment restricts how far into the future you can look when determining bad debt provisions for each year, but with insurers, we've had reserving concepts for some time which require technical provision to reflect the expected eventual liability. So, for credit risk, I think you would need to have a different approach to capital between insurance and banking capital if the accounting differs. Also, at the end of the day, I do wonder what value this will end up being, given the potential confusion that may arise. Understanding cross concentrations may be helpful, but a common capital standard across sectors will be difficult – and

“ So, overall, it's an important role and, equally important as we move into ComFrame and a level playing field, it should not just be about capital, but how the information is used to better achieve supervisory outcomes. ”

– Sue Kean,
Old Mutual Group

besides, in practice not many integrated conglomerates remain these days anyway’.

Similarly, AL noted that *‘the time of putting everything together is over – there should be horses for courses – though you can have some common themes – such as the treatment of sovereign risk weights across sectors. In this regard, there should be consistent regulatory treatment and there should be commonality in approach, for example, in regards to equity risk weights – the asset treatment across sectors should be treated similarly. Similarly, confidence intervals across sectors could also be harmonized – but not necessarily an integration of those frameworks’.*

From a regulatory perspective, GB was of the view that *‘Convergence in the supervisory approaches of the different financial sectors is a very appealing concept and we have been witnessing a clear trend towards a more consistent treatment of similar risks. That facilitates the mutual understanding between supervisors and therefore simplifies conglomerate supervision. Furthermore, ensuring that similar risks are treated in the same way, avoids incentives for capital arbitrage by market participants, limiting the concentration of risks in those sectors where they are treated in a more benevolent way.*

However, I do believe that this convergence should only develop to the extent that the specificities of business models are properly recognized. In fact, the specificities of the insurance business and its inherent risks make it very difficult to obtain reasonable results through the application of a capital framework which has been designed with a banking mind-set. And the same applies for the banking sector. Despite its potential appeal, we should move away from the concept of applying one single standard across all financial sectors, as it will produce sub-optimal results for all of them.

The specificities of the insurance business models make it very different from banking business. And the capital framework must be sensible to these specificities, dealing appropriately with features such as the very long term nature of a substantial portion of insurance business and also creating the right incentives for proper risk management, which is a fundamental element of insurance.’

KM expressed similar views and stated that *‘I think you may see more convergence in thought on methods and measures, but as far as common capital and risk requirements, I think there will always naturally be some differences across sectors. I say this because I think it is short-sighted to think of risk as an absolute; they should be viewed in a portfolio context. A risk that could be seriously inappropriate or damaging within one portfolio may actually be a good fit within another. As a crude example, overnight funding arrangements are a good fit in many banks and as such would have an appropriate capital charge. That same agreement could be a very bad fit for a life or annuity provider however. We need to look for comparability of outcomes in assessing risk and the ability of companies to perform in times of stress. If we gain a common understanding of risk, we will have come a long way’.*

IAIS developments and the future of insurance supervision

As a final question to our respondents, we asked what changes in insurance supervision would they like to see or consider necessary, given the IAIS is now entering its 21st year as a global standard setter for insurance. A number of different responses were received.

HG outlined three areas of focus he would like to see:

‘1. Continue to promote common standards and best practice across the industry.

Despite its potential appeal, we should move away from the concept of applying one single standard across all financial sectors, as it will produce suboptimal results for all of them.

Gabriel Bernadino,
Chair, EIOPA



If nothing else the whole ComFrame discussion has got different players talking about the issues and pooling their experience.

2. Important though the subject is, we should try not to let the issue of capital dominate discussions...capital offers protection in a crash to make sure no one gets hurt. I want to make sure we don't have a crash in the first place and to that end I welcome the opportunity to share ideas with regulators and other industry participants – the IAIS is a useful forum for that.

3. In that vein, I would also like to see the IAIS promote wider discussion of the industry and its role in society. In particular the virtuous circle of providing a safety net in the form of protection and savings products and using the premiums from those products to invest in the development of the countries in which we operate should be considered as part of a wider discussion on policyholder protection. I think the IAIS can influence the development of regulators as partners as well as overseers, rather like the Second Line in fact'.

Other CROs like ST were of the view that 'the IAIS should be more of a standard setting body, providing guidance to regulators for what acceptable standards should look like. I think there may be some gaps for some insurance group holding companies and for non-regulated activities, especially where many don't have a group supervisor such as in the US, and the IAIS could play a role here'.

SK stated that 'some of the basics from the Insurance Core Principles, such as establishment of the regulator, no political interference, professional secrecy, need to cover conduct and prudential regulation etc. are really helpful. Core principles have achieved a lot. However, I think it's lost its way a bit, for example, by focusing

too much on things which may not be achievable. Reaching a final decision is also limited as the IAIS works on a consensus basis. However, if you're a smaller country, then a lot of the IAIS framework is useful due to the ICP requirements and analysis undertaken by the IMF with its Financial Sector Assessment Program. The question remains though for the ICS, is this going to be a conceptual model or be like a Basel framework?'

AL was of the view that 'the whole discussion around the global financial crisis and systemic risk has shown perhaps that the IAIS has not had the same clout as others. We need a highly credible voice that can speak for the insurance industry and what the real issues are that the sector faces. In dealing with central bankers and politicians, an increased profile with credible dialogue is needed. Further, enhancement and convergence in the regulatory world is continuing – for example, capital standards, regulatory requirements – and there is a sharp focus generally on the supervisory and regulatory agenda. However, I think there is too much coming into insurance from banking, whether that be from political pressure or in response to that sector's conduct issues. The aim for the insurance sector should be policyholder protection and this is what insurance regulation should be focused on.

Putting the customer at the heart is good but for the state itself through for example conduct regulators to have this as an agenda is perhaps interesting. Competition should be there, no question – but should regulators be drilling down into everything an organization does? Is this not what executive management and the board are responsible for doing? Certain roles and responsibilities are unclear in this regard and the focus for regulators should squarely be on capital and liquidity management.'

/// Important though the subject is, we should try not to let the issue of capital dominate discussions...capital offers protection in a crash to make sure no one gets hurt. I want to make sure we don't have a crash in the first place. ///

– **Hugh Graham,**
AIA Group

Providing a regulatory perspective, GB shared his view that *'In the coming years I would like to see the IAIS developing as a truly international standard-setter. It is crucial that international standards in insurance are developed at the level of the IAIS. The IAIS made a very ambitious commitment and of course a lot of effort will be required in order to fulfil this commitment, including at organizational and governance levels. Going forward I see a constant challenge for insurance supervision in adapting to a more globalized market. Furthermore, insurance regulation and supervision will need to cope with the fundamental changes in insurance*

business models that we will witness in the coming decade, fuelled by the low interest environment, the digitalization of financial services and emerging threats like cyber-attacks.'

KM added, 'Moving forward, I would like to see the IAIS not only continue its standard setter role, but also to evolve into more of a support organization for insurance supervisors, whether it is in helping to implement best practices in jurisdictions seeking help, or acting as a technical support clearinghouse for accounting and regulatory understanding among member supervisors.'

It is clear from our interviews that both industry practitioners and regulators recognize the value in achieving greater international consistency and harmonization of insurance requirements. Similarly, there was strong support for the continuation of supervisory colleges and ongoing cooperation and engagement by supervisors with each other. Generally the consensus was that the college process should in itself lead to a convergence of regulatory practices over time.

KPMG Perspective

It is clear from our interviews that both industry practitioners and regulators recognized the value in achieving greater international consistency and harmonization of insurance requirements. Similarly, there was strong support for the continuation of supervisory colleges and ongoing cooperation and engagement by supervisors with each other. Generally the consensus was that the college process should in itself lead to a convergence of regulatory practices over time.

Notwithstanding these sentiments, concerns were raised as to whether this could practically be achieved, particularly in relation to how the new global standards would interact with local laws. The need to recognize the regional differences in insurance products, exposures and the distinctions between insurance and other financial sectors was also considered to be necessary preconditions for an effective global framework. It remains unclear from the current ICS consultation paper how such issues will be addressed, but the decision to allow more time for the debate may help resolve some concerns raised by the interviewees.

The uncertainty surrounding these issues is unhelpful, especially considering the IAIS has commenced the process of developing a framework before reaching an agreed implementation commitment from regulators, which includes not yet having consensus concerning the appropriate level of policyholder protection. Such outcomes raise the very real prospect of duplicate or contradictory regulations emerging which seemingly goes against the overriding aim and expected benefits of achieving greater consistency and harmonization of requirements by having an ICS.



Conduct risk – The evolving nature of conduct risk and regulatory expectations

Globally, conduct risk remains one of the most bespoke characteristics of insurance regulation with each country prescribing different requirements and treatment of consumer expectations, leaving many insurers uncertain as to how best to approach the management of conduct risk within their organizations. The development of a twin peaks approach separating conduct issues from prudential supervision has likely increased the diversity in approaches.

In response, the IAIS has tried to set standards for conduct risk and has recruited a number of the freestanding conduct supervisory authorities into the IAIS membership.

As stated earlier in this paper, there is a single ICP that covers conduct of business which was adopted in 2011. As the box on page 48 shows, the standards contained within ICP 19 are set at a high principles-based level, which may help explain why there has been less movement globally towards convergence in conduct of business regulation than solvency regulation. But the IAIS is beginning to further delineate its conduct approach. The IAIS recently released application papers to assist in understanding the supervisory role, including a 2014 paper entitled *Approaches to Conduct of Business Supervision*. The IAIS is now preparing a guidance paper on Conduct of Business Risk, which it hopes to complete by the end of 2015.

In addition to the IAIS, two other networks are helping push for increased global activity. The OECD has a Task Force on Financial Consumer Protection, which maintains a listing of tools available for supervisors and identifies emerging challenges in the area of consumer protection. The OECD also provides secretariat support to the International Financial Consumer Protection Organization (FinCoNet), an international organization of supervisory authorities with responsibility for financial consumer protection.

Finally, we have seen movement in the US, Canada and Europe to increase harmonization of local conduct rules in the various states, provinces and Member States, even though the primary responsibility continues to rest at the local level.

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// The supervisor requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, such advice is appropriate, taking into account the customer's disclosed circumstances. **//**

ICP 19 Conduct of Business:

Fair Treatment of Customers

- 19.1: The supervisor requires insurers and intermediaries to act with due skill, care and diligence when dealing with customers.
- 19.2: The supervisor requires insurers and intermediaries to establish and implement policies and procedures on the fair treatment of customers that are an integral part of their business culture.

Pre-sale Process

- 19.3: The supervisor requires insurers to take into account the interests of different types of customers when developing and marketing insurance products.
- 19.4: The supervisor requires insurers and intermediaries to promote products and services in a manner that is clear, fair and not misleading.
- 19.5: The supervisor sets requirements for insurers and intermediaries with regard to the timing, delivery, and content of information provided to customers at point of sale.
- 19.6: The supervisor requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, such advice is appropriate, taking into account the customer's disclosed circumstances.
- 19.7: The supervisor requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, any potential conflicts of interest are properly managed.

Policy Servicing

- 19.8: The supervisor requires insurers to:
 - service policies appropriately through to the point at which all obligations under the policy have been satisfied
 - disclose to the policyholder information on any contractual changes during the life of the contract
 - disclose to the policyholder further relevant information depending on the type of insurance product.
- 19.9: The supervisor requires that insurers have policies and processes in place to handle claims in a timely and fair manner.
- 19.10: The supervisor requires that insurers and intermediaries have policies and processes in place to handle complaints in a timely and fair manner.
- 19.11: Legislation identifies provisions relating to privacy protection under which insurers and intermediaries are allowed to collect, hold, use or communicate personal information of customers to third parties.
- 19.12: The supervisor requires insurers and intermediaries to have policies and procedures for the protection of private information on customers.
- 19.13: The supervisor publicly discloses information that supports the fair treatment of customers.

The evolving nature of supervisory practice

Many supervisors are evolving their approach to conduct risk supervision to encompass specific new powers including the ability to prevent the release of high-risk products or to withdraw misleading financial promotions. An example of such change is EIOPA's initiative on product governance, product suitability, appropriate selling practices and better information for consumers as detailed in the EMA section of this report.

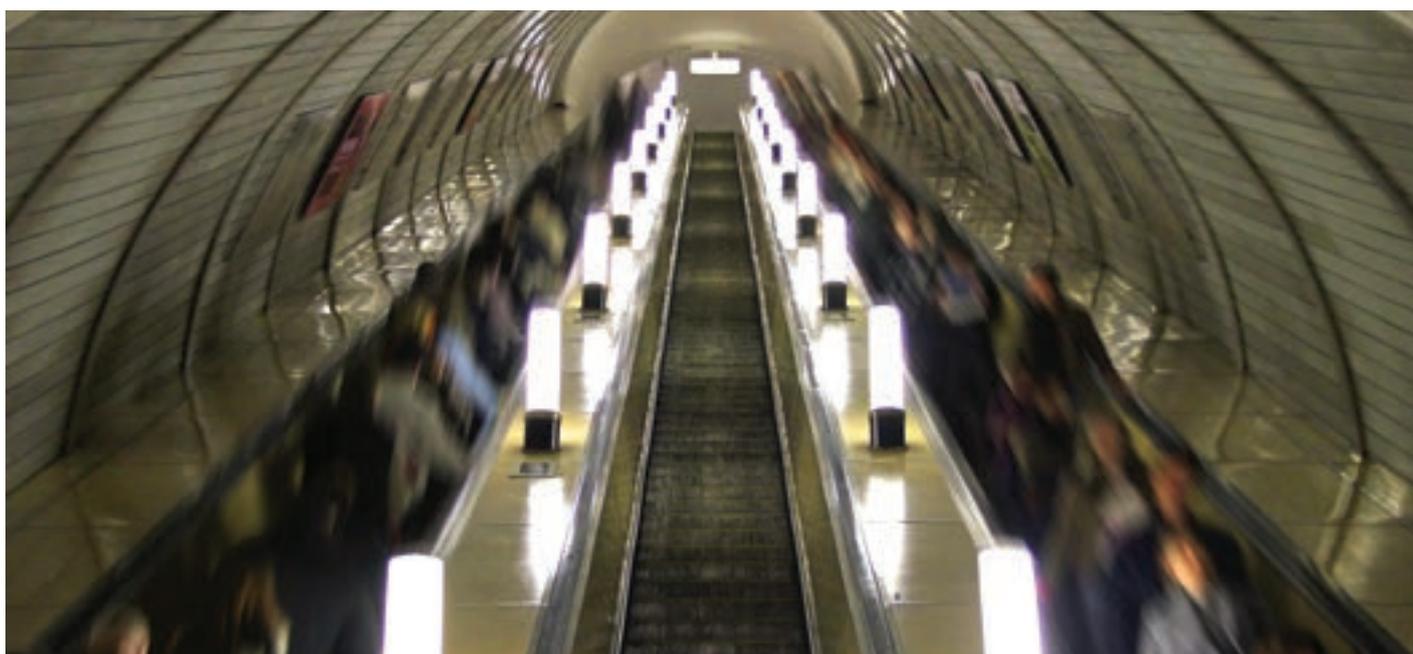
Other key tools include:

- New assessment methodologies
- Firm-wide assessments
- A focus on prevention
- Evaluation of risks across the product lifecycle
- More aggressive enforcement tools and
- Sector-wide intervention.

Similar to the new regulatory approach to risk management, conduct risk supervision will seek to change the culture of firms. Increasingly supervisors want to move beyond merely reviewing company policies and frameworks. They are now assessing whether firms are operating in the customer's interests in decisions. It is not just about tone from the top that they seek, it is tone throughout the firm – particularly the 'tone from the middle' where often issues can arise.

The IMF and the World Bank have been looking closely in the Financial Sector Assessments at conduct issues and have urged jurisdictions to implement active oversight and enforcement programs. They are urging supervisors to more closely supervise intermediaries, including requiring disclosure of interests and documented policies and procedures. The reports also urge increased funding for conduct activities and greater use of onsite inspections. The 2014 IMF reviews all mentioned the need for supervisors to address product design and promotion materials, going as far as recommending that supervisors have the authority to ban certain products.

// The IMF and the World Bank have been looking closely in the Financial Sector Assessments at conduct issues and have urged jurisdictions to implement active oversight and enforcement programs. //



The key challenges for insurers

There have been many examples in the past few years in which errors in conduct compliance have resulted in substantial fines for financial services firms. In the UK, our experience with some firms suggests that for every £1 spent on compliance, up to as much as £16 has been spent on remediation.

The primary responsibility for managing conduct risk should be with those who face it when making day-to-day or strategic decisions – namely the front line. However, managing conduct risk is the responsibility of all parts of a firm and often, specific functions are accountable for establishing the framework around conduct risk. There are

variances in where this function reports into, for example, some are direct to the CEO and some are to a Board level CRO. Some firms have established specific committees with the primary purpose of governing conduct risk, while others have utilized existing frameworks.

Globally, however, for many insurers management of conduct risk is still early in transition and for some, it is at a very early stage. Developing a conduct risk appetite that drives decision-making is a necessary first step in addressing compliance. Such statements could include a combination of quantitative and qualitative tolerance statements and metrics.

Figure 10: Key challenges facing insurers

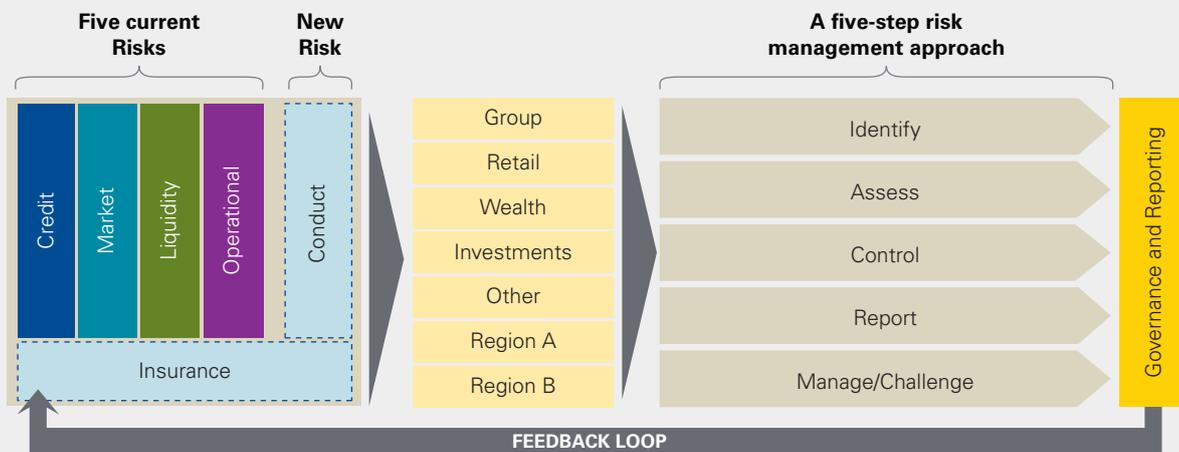


Source: KPMG International, 2015.

For some time, insurers have focused heavily on principal risks such as insurance, credit, market and liquidity risks; with conduct risk sometimes being a subset of operational risks – particularly in instances where risks crystallize into incidents and issues. However, many insurers are now

viewing conduct risk as a new risk type, separate from operational risk. The introduction of this as a new risk category inevitably impacts the management of existing risks in the areas where they interact. Figure 11 illustrates this dynamic.

Figure 11: Fit within the Enterprise Risk Framework



Source: KPMG International 2015.

As conduct risk becomes an important risk category in its own right, the definitions of Operational and Conduct risk mean that there is a clear potential for overlap. In order to

manage the overlap, decisions will need to be made about how to handle each individual risk. Possible options are shown in Figure 12.

Figure 12: Boundaries with operational risk

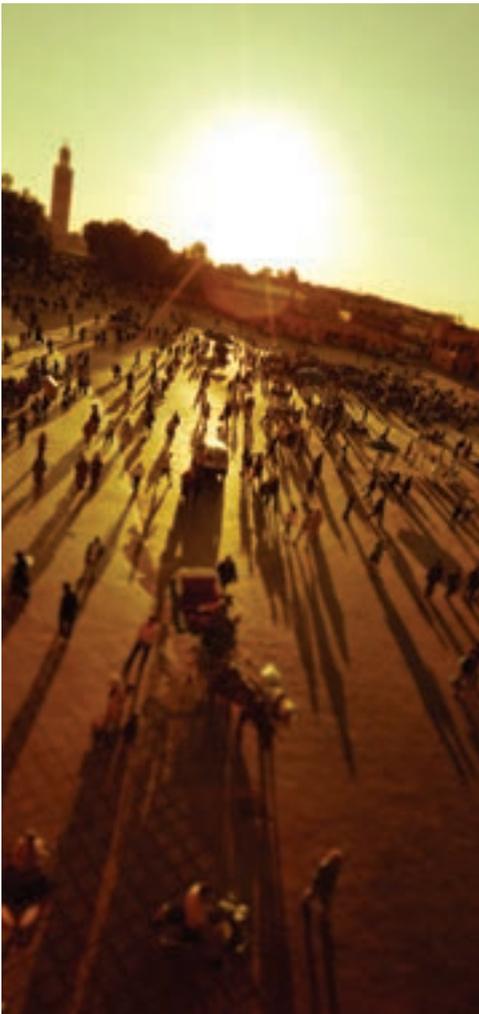
Regulatory Relationships	Transaction processes	Roles & accountability		Inappropriate literature		KYC
IT security	Payment systems	Data protection	Employee conduct	Incentives	AML	Bribery & corruption
Competition law	Risk management	Misuse/ loss/ changes of data	Reward legislation & policy	Product design	Sanctions	Conflicts of interest
People capability	Data privacy	Change management	Conduct Risk escalation	Sales practices	Product operates as expected	Identify/ prevent market abuse
External fraud	Recruit & retain	Internal fraud		Customer selection & monitoring	Product adequacy	Complaint handling

Source: KPMG International 2015.

It should be noted that some firms also opt for dual reporting rather than trying to separate individual types of risk. However, whichever model is chosen, some realignment of existing risks will be necessary between operational and conduct risks, including risk control frameworks, risk control assessments

and policies that control specific risks (for example people policies).

In addition, where relevant, specific capital requirements for conduct risks may also need to be set separately and fed into the overall risk capital calculations.



Implications for firms

Regulators are moving towards a forward-looking, proactive, and judgement-based supervisory approach. This increased focus on consumer outcomes means that regulators are not just interested in the control environment, they are interested in firms' business models and strategies (for example, consideration of the key drivers of profit and whether consumers are being treated fairly in the sale of these products). They will seek to identify potential risks to consumers at the very highest levels of decision-making. In particular:

- Firms will need to understand that conduct risk considerations impact many areas of their business including enterprise level governance, specific lines of business that deal directly with the consumer, data, process and systems throughout core and business support functions.
- Firms will need to demonstrate that consumers are central to

their strategy and business and that they deliver fair consumer outcomes.

- As part of the strategic planning process, a measured conduct risk assessment should be undertaken to ensure that the strategy could be modified, if required, before conduct issues arise.
- Insurers will need to challenge their business models and strategies to identify the drivers of their conduct risks.
- Importantly, firms will need to ensure that supervisory concerns are met otherwise they risk supervisors using pre-emptive supervisory tools, for example, that may directly influence an insurer's strategy.
- Senior Executive and management will therefore need to review their business through a different lens and take the opportunity to review historic decisions and the customer consequences of them.



The rising importance of risk culture

The effects of the global financial crisis continue to reverberate within the regulatory community as supervisors increasingly turn their attention to risk culture and gaining a better understanding of how boards and management can more effectively manage their strategic and operational risks. The value of a strong culture, an insurer's assessment of their own organization's risk culture, and the practical steps that can be taken to improve current risk practices in the organization now need to be key priorities for firms.

In October 2014, New York Federal Reserve Bank President, William Dudley,⁹ warned senior financial executives to act now. "If those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist. If that were to occur, the inevitable conclusion will be reached that your firms are too big and complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively. It is up to you to address this cultural and ethical challenge."

The IAIS has also been examining governance issues and effective structures and cultures within companies. In October 2014 the IAIS published an issues paper on '*Approaches to Group Corporate Governance: impact on Control Functions*'. This paper describes one of the key characteristics of good governance as being "the ability to promote a sound risk and compliance culture across the group."

The IAIS also conducted a self-assessment peer review on the governance ICPs in the first half of 2014. Standard 8.4 reads: *The supervisor requires the insurer to have an effective*

*compliance function capable of assisting the insurer to meet its legal and regulatory obligations and promote and sustain a corporate culture of compliance and integrity.*¹⁰ The review highlighted that many supervisors need to distinguish between a legal function and a function focused on compliance in the sense of ICP 8. Following the review, the IAIS Expert Team suggested that the IAIS reiterate the importance of a compliance function in an insurer's overall governance framework and that it provide more guidance on the nature of such function. The IAIS is reviewing ICP 8 and will in all likelihood include more detail on risk appetite and risk culture in line with the recent work of the FSB.

Finally, the OECD is revising its 2004 corporate governance principles. Proposed changes will include:

- More language on international cooperation
- A new section on shareholder rights
- A new chapter on incentives, disclosure, and high frequency trading
- New requirements on disclosure and transparency including sustainability reporting, disclosure of beneficial ownership, political donations, related party transactions

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9. Workshop on '*Reforming culture and behavior in the financial services industry*', New York Federal Reserve Bank, New York, 20 October 2014.

10. Insurance Core Principle 8, Risk Management and Internal Controls, IAIS, Basel, October 2011.

// The OECD will be issuing thematic peer reviews on board practices, the role of institutional investors, related party transactions, board nominations and elections, supervision and enforcement, and risk management and corporate governance. //

- A section on the responsibilities of a board, including risk management systems, direct board reporting, internal audit function, remuneration, and tax-planning strategies.

In preparation, the OECD will be issuing thematic peer reviews on board practices, the role of institutional investors, related party transactions, board nominations and elections, supervision and enforcement, and risk management and corporate governance.

Effective Risk Appetite Framework

The New York Federal Reserve warning followed the release by the FSB of its “*Principles for an Effective Risk Appetite Framework*” (Principles), finalized in November 2013¹¹, and a framework for assessing risk culture in April 2014.¹²

The FSB’s Principles set out key elements for:

- An effective risk appetite framework (RAF)
- An effective risk appetite statement
- The consideration of risk limits
- Defining the roles and responsibilities of the board of directors and senior management.

The FSB noted that “establishing an effective RAF helps to reinforce a strong risk culture at financial institutions, which in turn is critical to sound risk management.” The FSB further stated that “a sound risk culture will provide an environment that is conducive to ensuring that emerging risks that will have material impact on a firm, and any risk-taking activities beyond the firm’s risk appetite, are recognized, escalated, and addressed in a timely manner.”

In addition to providing an outline of the roles and responsibilities for an entity’s Board of Directors, the Principles include guidance for senior management positions, including the CEO, CRO, CFO, business line leaders and legal entity-level management, and internal audit.

For an “effective RAF” to influence conduct risks, it should:

- Establish a process for communicating the RAF across and within the financial institution
- Be driven by both top-down board leadership and bottom-up involvement of management at all levels
- Act as a defense against excessive risk taking
- Allow the risk appetite statement to be used as a tool to act as a basis upon which the board, risk management and internal audit functions can effectively and credibly debate and challenge management recommendations and decisions.

Risk Culture

The FSB’s “*Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*”¹³ includes “foundational elements that contribute to the promotion of a sound risk culture within a financial institution” and identifies for supervisors “core practices and attitudes that may be indicators” of an institution’s risk culture. These foundational elements of a sound risk culture include risk governance, risk appetite, and compensation; however, the FSB stressed the list of indicators is not “exhaustive” and that looking at one indicator in isolation would “ignore the multi-faceted nature of risk culture.”

11. Financial Stability Board, *Principles for an Effective Risk Appetite Framework*, 18 November 2013. http://www.financialstabilityboard.org/wp-content/uploads/r_131118.pdf?page_moved=1

12. Financial Stability Board, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, 7 April 2014. http://www.financialstabilityboard.org/wp-content/uploads/140407.pdf?page_moved=1

13. Financial Stability Board, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, April 2014. <http://www.financialstabilityboard.org/wp-content/uploads/140407.pdf>

The FSB Guidelines state that “supervisors should satisfy themselves that risk cultures are based on sound, articulated values and are carefully managed by the leadership of the financial institution.” This is a key reason why many supervisors are now examining risk culture in considerable depth looking for clear evidence that an appropriate dialogue around risk and the overall risk culture is taking place, and that those considerations are occurring at the right level within the organization.

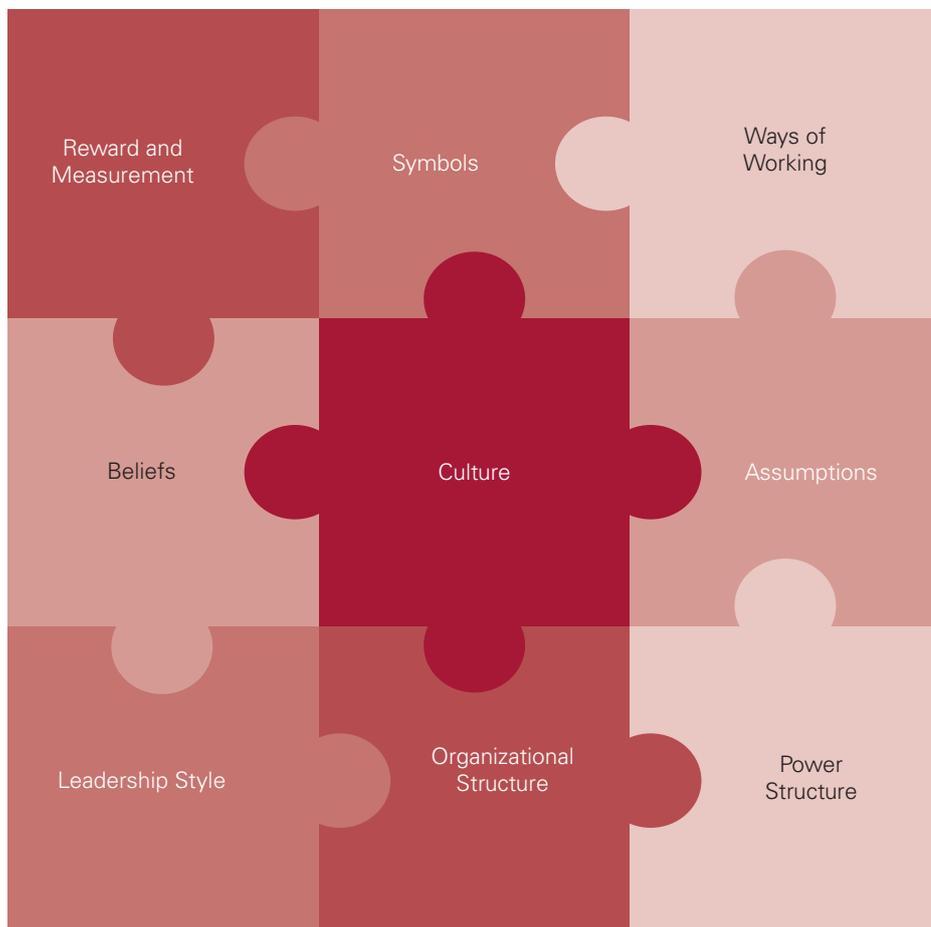
Despite this push, it can be challenging to articulate what risk culture actually means. We have defined risk culture as the manner in which decision makers at all levels within an insurer consider and take risks. A strong risk culture implies a shared set of objectives that encourages

people to be conscious of risk, to understand the trade-offs between risk and reward, and to make decisions about risk that are in the interests of the whole organization rather than the individual.

While we discuss risk governance and risk appetite in this chapter, the third issue - compensation - will grow in importance during the next year. Having nearly completed its work in banking, the FSB will specifically look at insurer compensation and its links to risk management, beginning with public consultations in May 2015.

Attitudes towards risk taking are an integral part of overall cultural profile and, consequently, reflect the key elements of an insurer’s performance, as can be seen in Figure 13.

Figure 13: Key elements of insurers’ performance



Source: KPMG International 2015.

/// The prevailing view amongst many supervisors is that without an appropriate 'risk culture', a robust, effective risk management framework is unlikely. ///

The global financial crisis demonstrated that some insurance groups accepted risks (sometimes unknowingly) far in excess of their boards' and other stakeholders' expectations, leading to significant losses. Many of these failings were the result of poor cultural attitudes and behaviors towards risk.

Reflecting this concern, supervisors are realising that an effective risk culture is at least equally as important as stringent regulatory compliance. The prevailing view amongst many supervisors is that without an appropriate 'risk culture', a robust, effective risk management framework is unlikely. Importantly, regulators are signalling a move from a focus on process to a focus on behavior. The challenges this creates for the industry in terms of demonstrating practice is in line with supervisory expectations will be key.

Many insurers are beginning to recognize that as their risk management processes mature, their failure to promote and maintain a robust risk culture means these processes will be ineffective and unsustainable in

the medium to long term. A strong risk culture, where people act in the interests of the whole organization rather than a narrower set of interests, is critical to the way in which an insurer creates and protects value.

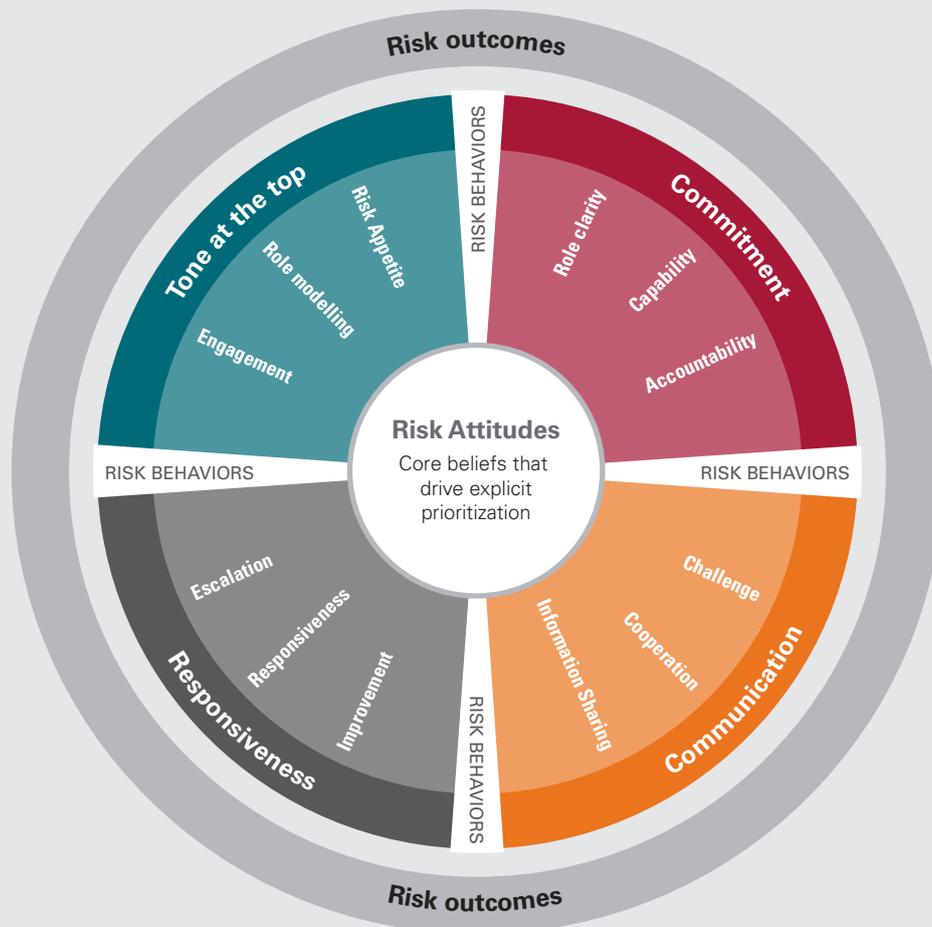
A strong risk culture possesses several characteristics:

- It delineates the organization's risk appetite, defines a risk management framework and ensures that these are understood and embraced by the whole organization
- It enables threats or concerns to be identified and escalated in a timely manner
- It increases clarity and transparency over individuals' responsibilities towards risk taking and risk avoidance
- It promotes a culture of continuous [risk related] improvement and learning from experience
- It aligns individual and organizational interests, increasing the prospect that corporate objectives will be achieved.



Through our studies of organizations with a robust risk culture, we have observed four key risk attitudes.

Figure 14: Key Risk Attitudes



These key risk attitudes can be further defined as follows:

Figure 15: Key risk attitudes

Tone at the top	A strong risk culture is driven from the top by the board and executive management
Communication	Employees are active in sharing information across the organizations and feel safe in escalating issues as they arise
Responsiveness	Employees understand their responsibilities for risk management and how to apply the risk management strategy
Commitment	Employee incentives are aligned to the overall objectives of the organization

Source: KPMG International 2015.

Culture equals actions, not policies or further documentation

As risk management matures, risk managers may struggle to realize the benefit of their existing risk management frameworks because no matter how good their risk management approach is, execution depends on the actions of employees. Few insurers have invested the resources necessary to truly understand and improve their employees' risk management behaviors.

As noted previously, however, there is a growing realization in boardrooms, executive suites and stakeholder groups that, without a strong risk culture, an insurer's investment in risk processes and frameworks will be neither effective nor sustainable. When embedded, an effective risk culture demonstrates distinctive characteristics. These characteristics can be shown to impact across a wide set of dimensions to improve the efficiency and effectiveness of decision-making and create value sustaining outcomes.

Table 11: Risk culture dimensions and value creation

Element	Dimension		
Tone at the Top	<p>▶ Clarity</p> <ul style="list-style-type: none"> • Employees understand the organization's risk management strategy and approach. 	<p>▶ Role Modelling</p> <ul style="list-style-type: none"> • Management sponsor and lead risk management activities. 	<p>▶ Enforcement</p> <ul style="list-style-type: none"> • Management reward desired behavior and take action when inappropriate risks are taken.
	<p>▶ Openness</p> <ul style="list-style-type: none"> • Flow of risk information up and down organization • Individuals willingness to share good and bad news. 	<p>▶ Involvement</p> <ul style="list-style-type: none"> • Flow of communication on risk between groups/departments. • Involvement of the right people to identify, assess and mitigate risks. 	<p>▶ Insight</p> <ul style="list-style-type: none"> • Understanding of the risk profile, risk appetite and capacity at various levels, including individual, team, department and company.
	<p>▶ Leadership</p> <ul style="list-style-type: none"> • Perception of the tone set by executives through encouragement of good risk management behavior and reflected through decision making. 	<p>▶ Motivation</p> <ul style="list-style-type: none"> • Belief in the value of risk management. • Alignment of rewards and KPIs with good risk management behavior. 	<p>▶ Learning</p> <ul style="list-style-type: none"> • Work environment's support for risk management learning and development. • Focus on continuous improvement for risk management.
Communication	<p>▶ Adherence</p> <ul style="list-style-type: none"> • Conformity with policies and procedures. • Alignment of behavior with the spirit of risk management. 	<p>▶ Responsiveness</p> <ul style="list-style-type: none"> • Timeliness of response. • Accountability for managing risks. 	<p>▶ Competency</p> <ul style="list-style-type: none"> • Feeling of adequacy/confidence in managing risk.
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Source: KPMG International 2015.

Key actions insurers can take to improve their risk culture

Few insurers excel in every aspect of their risk culture. The best ones, however, focus on constant improvement. They understand that expectations and standards for how they manage risks are high and that the benefits from strong risk management are compelling. Importantly, successful insurers understand that people create value. Driving positive changes in behavior aligns with creating shareholder value.

The benefits from having a strong risk culture are clear:

- Fewer surprises around performance and volatility
- Confidence and trust in the organization's integrity and resilience and
- Stronger and more robust stakeholder relationships.

Implications for insurers

- Boards should be able to articulate the desired features of an effective risk culture for their organization (i.e. the elements of risk culture that they wish to see in their company) and compare this to the actual existing features that might presently reside to assess the gap(s) that may exist.
- Boards should be capable of identifying features of risk culture that they do not want to see in their organization.
- Boards should be able to demonstrate the initiatives that have been undertaken in the organization over the past 12 months to promote and assess the desired risk culture, and importantly, know what measures need to be taken to influence the risk culture in the organization going forward.
- Boards must ensure that risk, finance and business lines and operational functions work together effectively to form a coherent strategy to achieve earnings stability, solvency and sustainable growth. In this regard, an appropriate risk appetite should be defined, well-articulated and appropriate for the organization.
- Boards must ensure that risks are being comprehensively and reliably identified, measured, managed and controlled in a manner consistent with the organization's risk appetite.
- Boards must be able to demonstrate that all staff understand and abide by the risk management framework relevant to their areas of responsibility.
- Boards must ensure that the remuneration arrangements for all staff create incentives to promote the long-term financial soundness of the organization.





The impact of accounting changes on regulation

As the international developments chapter of this publication shows, the IAIS is moving towards a market consistent basis of valuation for both assets and liabilities to underpin the determination of regulatory capital for its new BCR and ICS assessments. One of the most significant challenges for the IAIS has been that there is no consistent basis of accounting applied across jurisdictions – either for regulatory or financial reporting purposes.

Application of a harmonized financial reporting framework would have significant advantages for both the IAIS's work and the practical application of the final requirements. With this in mind, we consider below the latest position regarding international efforts to create a global insurance accounting standard and how this may interact with the IAIS's work.

There are signs that the International Accounting Standards Board's (IASB) *Insurance Contracts* project (IFRS 4 Phase 2) might be finally drawing to a close after many years of deliberations. A revised exposure draft was issued for public comment in June 2013, with the Financial Accounting Standards Board (FASB) issuing a separate exposure draft containing its proposals based on a similar model. Since then, the FASB has changed the direction and scope of its insurance project and is now considering only targeted improvements to current US GAAP, so the IASB has continued its project alone.

Under current International Financial Reporting Standards (IFRS), insurance contract liabilities are typically measured in accordance with accounting policies grandfathered from other accounting regimes (for example US GAAP or UK GAAP). Many unlisted insurance companies continue to report under their local GAAP requirements, rather than IFRS. Additionally, non-uniform accounting policies may be used in consolidated IFRS financial statements if this was permitted under the group's previous accounting policies, such as in UK GAAP. Consequently, there is little comparability between different

insurance groups. For the first time, IFRS 4 Phase 2 will require consistent accounting for insurance contracts, providing the ability to analyse results more meaningfully.

Current expectations are that IFRS 4 Phase 2 will not be issued before the end of 2015, suggesting an effective date of no earlier than 1 January 2019. Some insurers may consider early adopting the new insurance contracts standard to align with the effective date of IFRS 9 *Financial Instruments* (1 January 2018), although this might not be practical for many insurers. The new insurance contracts standard will be one of the most complex standards issued by the IASB and its implementation will not be straightforward, particularly for those that issue long-duration insurance contracts.

Regardless of the timing of practical application of the standard, it is clear that the IAIS cannot wait for the final version of IFRS 4 Phase 2 if it is to meet its own challenging timeline for production of the ICS proposals. However, it could revise its proposals, where meaningful to do so, to ensure greater harmonization between accounting and regulatory valuation bases at a later date. For this reason,

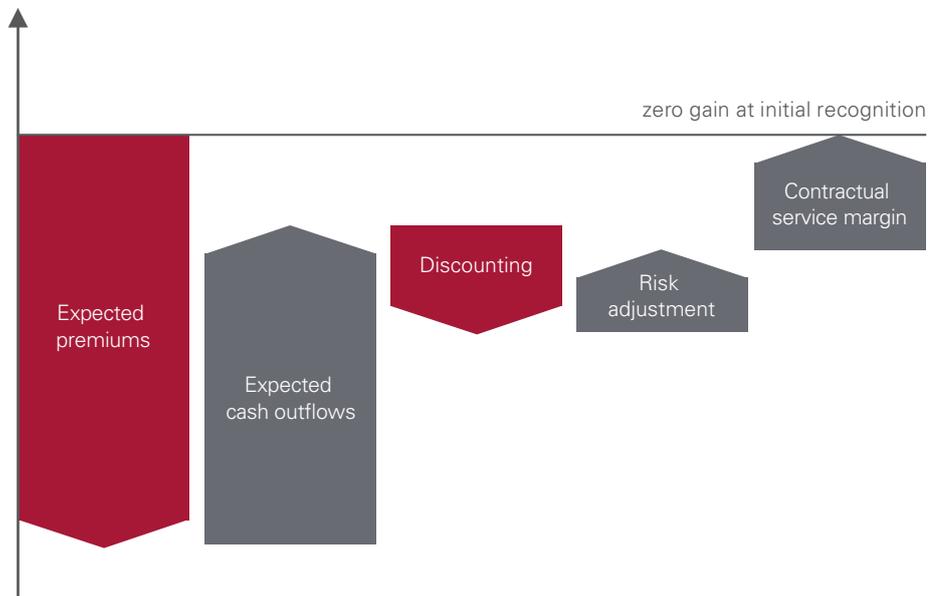
it is important that the changes to be introduced by IFRS 4 Phase 2 are understood from a regulatory, and not just an accounting, perspective.

Measurement basis

Under the new standard, the starting point for measuring an insurance contract liability will be the expected future cash flows for fulfilling the contract. The fulfilment of the obligation is based on the entity's perspective (fulfilment value, not exit value or fair value).

In measuring an insurance contract liability, the expected future cash inflows less outflows (building block 1) are discounted to reflect the time value of money (building block 2). A risk adjustment that reflects the uncertainty about the amount and timing of the cash flows (building block 3) is added to the discounted expected future cash flows. These three 'building-blocks' are re-measured at each reporting date using current information. If the sum of the three building blocks is a net asset, a contractual service margin (CSM) is added at the inception of the contract to remove any day-one gains.

Figure 16: Proposed measurement model



Source: KPMG International, April 2015.

The CSM represents the unearned profit at the inception of the contract. It is recognized over the coverage period in a systematic way that best reflects the remaining transfer of services provided under the contract. The claims settlement period is not included.

At subsequent measurement, the CSM is adjusted both for changes in future cash flows and changes to the risk adjustment that relate to future coverage and other future services, provided that the CSM does not become negative. Consequently, there is no impact on net income or equity.

The new standard does not prescribe how to determine the discount rate, but rather provides a broad objective: being consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract in terms of timing, currency and liquidity. Depending on the type of entity and insurance contract, and the methodology adopted to determine the

appropriate discount rate (or rates), a number of different discount rates might be applied. The disclosure requirements for discount rates, or ranges of discount rates, are intended to achieve transparency and market discipline.

For short-term contracts, in particular one-year insurance contracts, the new standard will permit the application of a simplified approach for pre-claims liabilities that is broadly consistent with unearned premium under current accounting practices for short-term duration contracts.

Post-claims liabilities, with certain exceptions, are measured using the building block approach. Profit will be recognized earlier than under most current accounting models, because post-claims provisions are generally not discounted, although if the risk adjustment exceeds the effect of discounting, which may be the case in particular for liability insurance, profit will be recognized later.

/// The new standard does not prescribe how to determine the discount rate, but rather provides a broad objective: being consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract in terms of timing, currency and liquidity. ///

Participating contracts

The treatment of participating contracts is the IASB's last critical challenge in its Insurance Contracts project. To the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depends wholly or partially on returns on underlying items (participating contracts), the discount rate should reflect that dependency. However, the

relevant guidance in the exposure draft is complex and in some circumstances inconsistent and difficult to apply. During 2014, the IASB has been considering alternative approaches; however so far no decisions have been taken. It remains to be seen how the building block approach and the presentation requirements will be modified so that they can be applied to this kind of business.

Key concerns

A key concern for the insurance industry is the extent to which volatility may arise in profit or loss from short-term interest rate fluctuations, which many believe would be inconsistent with the long-term nature of insurance business. The standard will provide an option to present changes in insurance liabilities arising from changes in discount rates either in other comprehensive income (OCI) or in profit or loss. If the OCI option is adopted the effect of unwinding the discount rate would be presented in profit or loss using the locked-in rate at contract inception. This would achieve a stable presentation in profit or loss, which would be mirrored by the treatment of financial assets classified as Fair Value through OCI (FVOCI) under IFRS 9 *Financial Instruments*.

However, many investments held by insurers may not meet the criteria for classification as FVOCI (for example derivatives, structured products or those with participating rights), and even if it were possible to classify all financial assets as FVOCI it would still not be possible to remove all sources

of volatility arising from economic or accounting mismatches. Alternative approaches are still being discussed regarding how to determine the unwinding of discount in profit or loss for participating contracts.

Insurers are also concerned that the effective date of IFRS 4 Phase 2 will now be later than the effective date for IFRS 9 and the IASB has recently been considering whether the proposed transition requirements in IFRS 4 Phase 2 need to be made more flexible. However, this would not address concerns about having to make two significant changes to key accounting policies in quick succession, the additional costs that would be incurred, and the challenge of explaining the impact of the changes to users of the financial statements.

The IASB's proposals include a new presentation for the statement of profit or loss and OCI. Under current accounting practices, earned premiums is a key volume measure. In the new presentation this measure will be replaced by a revenue measure that is based on concepts in the new

Revenue Recognition standard (IFRS 15) issued in May 2014. Under the new requirements, insurance revenue for life and health insurance will be significantly different from the current earned premiums measure, because the timing of recognition differs and all investment components will be excluded.

For ceded reinsurance, a CSM is determined for the reinsurance asset when the asset is first recognized to remove any gain or loss. Reinsurance premiums are reduced by ceding commissions that are not contingent on the occurrence of claims on the underlying contracts. As a result, for proportional reinsurance the reinsurance asset will not necessarily equal the reinsurer's share of the gross insurance contract liabilities. Profit recognition from the underlying insurance contracts and the reinsurance contract could therefore diverge (for example in an onerous portfolio) if losses from the underlying insurance contracts are anticipated and recognized at their inception.

KPMG Perspective

The IASB has made good progress in 2014 and has brought the publication of IFRS 4 Phase 2 closer to realization.

Providing an option to present volatility resulting from short-term interest rate fluctuations in OCI is more consistent with many insurers' long-term business models. However, a solution that best reflects the interaction between insurance liabilities and related assets for participating contracts has yet to be determined.

From our perspective, key areas of interest within the current proposals and their related impacts include:

- The extent to which the final standard includes options or requirements that would enable volatility to be removed from profit or loss and equity. For example, if changes in financial assumptions and the values of minimum guarantees due to short-term interest rate fluctuations are presented in profit or loss or could be offset against the CSM, volatility would be reduced.
- Insurers will need to have certainty over the measurement requirements in IFRS 4 Phase 2 before implementing IFRS 9. However, a final assessment of whether the IASB has comprehensively considered the interaction between the two accounting bases can only be made after the discussions on participating contracts have been completed.
- The requirement to calculate and maintain the CSM, both at transition and subsequently, will represent the most significant operational challenge for insurers, because there are no similar requirements in most current accounting models.
- The presentation of the statement of profit or loss and OCI and the new insurance revenue measure will represent a significant change to current practices and business metrics.

The IAIS is continuing development of an ICS, even though it has left open the date for finalization of a standard. As the initial basis to develop an example of a standard method, a market-adjusted valuation approach will be used that appears similar to the approach discussed by IASB. Differences may result with respect to the objective and treatment of the MOCE and the yield curve for discounting. As an alternative, the IAIS is still considering a "GAAP valuation approach" with the intention to enable IAIGs to determine comparable capital needs using local jurisdictional GAAP as a starting point, with incremental and quantifiable adjustments made therefrom.

Abbreviations

AEC	ASEAN Economic Community	EBS	Economic Balance Sheet
AEoI	Automatic Exchange of Information (Switzerland)	EC	Economic Capital
ALM	Asset Liability Management	ECR	Enhanced Capital Requirement (Bermuda)
APRA	Australian Prudential Regulation Authority	EIOPA	European Insurance and Occupational Pensions Authority
ASEAN	Association of Southeast Asian Nations	EMA	Europe, Middle East and Africa
ASPAC	Asia and Pacific Countries	ERM	Enterprise Risk Management
BCR	Basic Capital Requirement	FAIR	Financial Advisory Industry Review
BMA	Bermuda Monetary Authority	FASB	Financial Accounting Standards Board
BNM	Bank Negara Malaysia	FIDLEG	Swiss Financial Services Act
BNR	National Bank of Rwanda	FinCoNet	Financial Consumer Protection Organization
BWP	Botswana Pula	FINMA	Financial Markets Supervisory Authority (Switzerland)
C-ROSS	China Risk Oriented Solvency System	FIO	Federal Insurance Office (US)
CAP	Common Application Package for Internal Models	FLAOR	Forward Looking Assessment of Own Risks (Europe)
CAR	Capital Adequacy Ratio	FRB	Federal Reserve Board (US)
CBB	Central Bank of Bahrain	FSA	Financial Services Authority
CBO	Central Bank of Oman	FSAP	Financial Sector Assessment Program
CBRC	China Banking Regulatory Commission	FSB-SA	South Africa Financial Services Board
CEE	Central and Eastern Europe	FSB	Financial Stability Board
CEL	Current estimate of liabilities	FSC	Financial Services Commission (Korea), Financial Supervisory Commission (Taiwan)
CEO	Chief executive officer	FSDRP	Financial Sector Development and Regionalization Project
CFO	Chief financial officer	FSI	Financial System Inquiry
CIITMC	China Insurance Information Technology Management Company	FSOC	Financial Stability Oversight Council
CIRA	Commercial Insurer Risk Assessment	FSS	Financial Supervisory Service (Korea)
CIRC	China Insurance Regulatory Commission	FVOCI	Fair Value through Other Comprehensive Income
CISSA	Commercial Insurers Solvency Self Assessment	FVTPL	Fair Value Through Profit or Loss
CMA	Capital Markets Authority	G-SIIs	Global Systemically Important Insurers
CMGs	Crisis Management Groups	GAAP	Generally Accepted Accounting Principles
CMPTL	Compulsory motor third party liability business	GCC	Gulf Cooperation Council
ComFrame	A comprehensive supervisory framework for the supervision of internationally active insurers	GCP	Group capital proposal
CPI	Consumer Price Index	GDP	Gross domestic product
CRO	Chief Risk Officer	GICS	Guaranteed investment contracts
CSM	Contractual service margin	GSSA	Group Solvency Self Assessment
C&SR	Capital and Solvency Return (Bermuda)	HKMA	Hong Kong Monetary Authority
DIFC	Dubai International Financial Centre	HLA	Higher Loss Absorbency
D-SIFI	Domestic Systemically Important Financial Institution	IAA	International Actuarial Association
EEA	European Economic Area	IAIGs	Internationally Active Insurance Groups
EAC	East African Community	IAIS	International Association of Insurance Supervisors
		IASB	International Accounting Standards Board

IBNR	Incurring but not reported	PCR	Prescribed Capital Requirement
ICAAP	Internal Capital Adequacy Assessment Process (Australia)	PDPA	Personal Data Protection Act (Singapore)
ICPs	Insurance Core Principles	PHIAC	Private Health Insurance Administration Council (Australia)
ICS	Insurance capital standard	PRA	Prudential Regulatory Authority (UK)
IDD	Insurance Distribution Directive (Europe)	PRIIPs	Packaged retail and insurance-based investment products (Europe)
IFRS	International Financial Reporting Standards	QCB	Qatar Central Bank
IFSA	Islamic Financial Services Act	QFC	Qatar Financial Centre
IIA	Independent Insurance Authority (Hong Kong)	QFCRA	Qatar Financial Centre Regulatory Authority
IMF	International Monetary Fund	QIS	Quantitative Impact Studies
IRA	Insurance Regulatory Authority (Kenya and Uganda)	QRT	Quantitative reporting templates
IRCA	Insurance Regulatory and Control Agency (Burundi)	RAF	Risk appetite framework
IRDA	Insurance Regulatory and Development Authority (India)	RBC	Risk-Based Capital
ISO	Insurance Supervision Ordinance (Switzerland)	RBI	Reserve Bank of India
ITS	Implementing technical standards (Europe)	RBNZ	Reserve Bank of New Zealand
JFSA	Japan Financial Services Agency	RDR	Retail distribution review (South Africa)
KSA	Kingdom of Saudi Arabia	RRPs	Recovery and resolution plans
LAGIC	Life and General Insurance Capital (Australia)	SAM	Solvency Assessment and Management (South Africa)
LISF	Insurance and Surety Institutions Law (Mexico)	SAMA	Saudi Arabia Monetary Agency
MAS	Monetary Authority of Singapore	SARB	South African Reserve Bank
MCR	Minimum Capital Requirement	SCR	Solvency Capital Requirement
MiFID	Markets in Financial Instruments Directive (Europe)	SELIC	National Reference Interest Rate
MMoU	IAIS Multilateral Memorandum of Understanding	SFC	Securities and Futures Commission (Hong Kong)
MOCE	Margin Over Current Estimate	SMI	Solvency Modernization Initiative
NAIC	National Association of Insurance Commissioners (US)	SRMP	Systemic risk management plan
NAICOM	National Insurance Commission (Nigeria)	SSN	Superintendencia de Seguros de la Nación (Argentina)
NAMFISA	Namibia Financial Institutions Supervisory Authority	SST	Swiss Solvency Test
NARAB	National Association of Registered Agents and Brokers Reform Act	STCL	Supervisory target capital level
NBFIRA	Non-Bank Financial Institutions Regulatory Authority	SUSEP	Superintendence of Private Insurance (Brazil)
NIC	National Insurance Commission (Ghana)	TCF	Treating Customers Fairly
NTNI	Non-traditional non-insurance	TIRA	Tanzania Insurance Regulatory Authority
OCI	Office of the Commissioner of Insurance (Hong Kong)	TRIA	Terrorism Risk Insurance Act
OCI	Other Comprehensive Income	TVaR	Tail value at risk
OECD	Organization for Economic Co-operation and Development	UAE	United Arab Emirates
OIC	Office of the Insurance Commission (Thailand)	UIC	Uganda Insurance Commission
OJK	Indonesia Financial Services Authority	USTR	US Trade Representative
ORSA	Own Risk and Solvency Assessment	VaR	Value at risk
OSFI	Office of the Superintendent of Financial Institutions (Canada)		
PBR	Principles-based reserving		

Acknowledgments

We would like to acknowledge the contribution of our colleagues from across KPMG's global network of member firms who helped develop this report:

Americas region

Robert Kasinow

Director
KPMG in the United States
T: +1 973 912 4534
E: rkasinow@kpmg.com

Carl Groth

Managing Director
KPMG in the United States
T: +1 973 912 4873
E: chgroth@kpmg.com

Richard Lightowler

Managing Director
KPMG in Bermuda
T: +1 441 295 5063
E: richardlightowler@kpmg.bm

Neil Parkinson

Partner
KPMG in Canada
T: +1 41 6777 3906
E: nparkenson@kpmg.ca

Lorena Lardizabal

Senior Manager
KPMG in Argentina
T: +54 11 4891 5645
E: llardizabal@kpmg.com.ar

Ricardo Anhesini

Partner
KPMG in Brazil
T: +55 11 2183 3141
E: rsouza@kpmg.com.br

Luciene Teixeira Magalhães

Partner
KPMG in Brazil
T: +55 11 2183 3144
E: ltmagalhaes@kpmg.com.br

Roberto Muñoz Galaz

Partner
KPMG in Chile
T: +56 2 2798 1233
E: rmunoz@kpmg.com

Ana María Ramírez

Partner
KPMG in Mexico
T: +52 55 5246 8624
E: anamariaramirez@kpmg.com.mx

Meredith Evans

KPMG International
T: +1 416 777 3494
E: mlevans@kpmg.ca

ASPAC region

Rob Curtis

Executive Director
KPMG in Australia
T: +61 3 9838 4692
E: rcurtis1@kpmg.com.au

Hoa Bui

Partner
KPMG in Australia
T: +61 2 9335 8938
E: hbui@kpmg.com.au

Julian Braganza

Senior Consultant
KPMG in Australia
T: +61 2 9455 9883
E: jbraganza1@kpmg.com.au

Simon Donowho

Partner
KPMG in China
T: +852 2826 7105
E: simon.donowho@kpmg.com

Walkman Lee

Partner
KPMG in China
T: +86 10 8508 7043
E: walkman.lee@kpmg.com

Bo Huang

Senior Manager
KPMG in China
T: +861 08 5085 999
E: bo.huang@kpmg.com

James Anderson

Partner
KPMG in Hong Kong
T: +852 2143 8572
E: james.anderson@kpmg.com

Estella Chiu

Partner
KPMG in Hong Kong
T: +852 2847 5035
E: estella.chiu@kpmg.com

Clarice Yen

Partner
KPMG in Hong Kong
T: +852 2522 6022
E: clarice.yen@kpmg.com

Naresh Makhijani

Partner
KPMG in India
T: +91 22 3090 2120
E: nareshmakhijani@bsraffiliates.com

Shashwat Sharma

Partner
KPMG in India
T: +91 22 3090 2547
E: shashwats@kpmg.com

Elisabeth Imelda

Partner
KPMG in Indonesia
T: +62 21 574 2333
E: elisabeth.imelda@kpmg.co.id

Susanto

Partner
KPMG in Indonesia
T: +62 21 574 2333
E: susanto@kpmg.co.id

Takanobu Miwa

Partner
KPMG in Japan
T: +81 3 3548 5101
E: takanobu.miwa@jp.kpmg.com

Ikuo Hirakuri

Partner
KPMG in Japan
T: +81 3 3548 5101
E: ikuo.hirakuri@jp.kpmg.com

Ryuji Takahashi

Partner
KPMG in Japan
T: +81 3 3548 5125
E: ryuji.takahashi@jp.kpmg.com

Sung Min Cho

Partner
KPMG in Korea
T: +82 2 2112 0499
E: sungmincho@kr.kpmg.com

Jae Beom Choi

Partner
KPMG in Korea
T: +82 2 2112 0213
E: jaebeomchoi@kr.kpmg.com

WanKong Mok

Partner
KPMG in Malaysia
T: +60 3 7721 3388
E: wmok@kpmg.com.my

Kay Baldock

Partner
KPMG in New Zealand
T: +64 9362 5316
E: kbaldock@kpmg.co.nz

Europe Middle East and Africa

Ceri Horwill

Partner
KPMG in New Zealand
T: +64 9367 5348
E: cerihorwill@kpmg.co.nz

Frank Dubois

Partner
KPMG in Singapore
T: +65 6411 8187
E: fdubois@kpmg.com.sg

Kam Yuen Lau

Partner
KPMG in Singapore
T: +65 6213 2550
E: kamyuenlau@kpmg.com.sg

Paul Brenchley

Director
KPMG in Singapore
T: +65 6411 8402
E: paulbrenchley@kpmg.com.sg

Phoebe Chung

Partner
KPMG in Taiwan
T: +886 2 8101 6666
E: phoebechung@kpmg.com.tw

Albert Gau

Partner
KPMG in Taiwan
T: +886 2 8101 6666
E: agau@kpmg.com.tw

Grinni Hsiao

Partner
KPMG in Taiwan
T: +88 628 101 6666
E: grinnihsiao@kpmg.com.tw

Noel Ashpole

Partner
KPMG in Thailand and Myanmar
T: +66 2 677 2794
E: nashpole@kpmg.co.th

Phuc Truong

Director
KPMG in Vietnam
T: +84 8 3821 9266
E: pvtruong@kpmg.com.vn

Janine Hawes

Director
KPMG in the UK
T: +44 20 7311 5261
E: janine.hawes@kpmg.co.uk

Joachim Kölschbach

Partner
KPMG in Germany
T: +49 221 2073 6326
E: jkoelschbach@kpmg.com

Zdenek Tuma

CEE Coordinating Insurance
Partner
KPMG in Czech Republic
T: +42 02 2212 3390
E: ztuma@kpmg.cz

Adeel Mushtaq

Senior Manager
KPMG in Bahrain
T: + 973 1722 4807
E: adeelmushtaq@kpmg.com

Gerdus Dixon

Partner
KPMG in South Africa
T: + 27 8 2492 8786
E: gerdus.dixon@kpmg.co.za

Simon Nicholas

Director
KPMG in Isle of Man
T: +44 1624 681002
E: snicholas@kpmg.co.im

Sara Ellison

Sr. Marketing Manager
KPMG in the UK
T: +44 20 73112342
E: sara.ellison@kpmg.co.uk

Jimmy Masinde

Director
KPMG in East Africa
T: +254 709 576 295
E: jmasinde@kpmg.co.ke

Cecilia Awoye

Senior Manager
KPMG in Ghana
T: +233 302 770454
E: cawoye@kpmg.com

Amanor Dodoo

Partner
KPMG in Ghana
T: +233 302 770454
E: adodoo@kpmg.com

Anthony Sarpong

Partner
KPMG in Ghana
T: +233 302 770618
E: asarpong@kpmg.com

Jackline Chibai

Senior Manager
KPMG in Kenya
T: +254 202 806000
E: jchibai@kpmg.co.ke

Rachel Wangari

Associate
KPMG in Kenya
T: +254 202 806000
E: rachelwangari@kpmg.co.ke

Bisi Lamikanra

Partner
KPMG in Nigeria
T: +234 127 18962
E: bisi.lamikanra@ng.kpmg.com

Kabir Okunlola

Partner in Nigeria
KPMG in Nigeria
T: +234 1271 8955
E: kabir.okunlola@ng.kpmg.com

Gerdus Dixon

Partner
KPMG in South Africa
T: +278 2492 8786
E: gerdus.dixon@kpmg.co.za

Contacts

Jeremy Anderson
Chairman Global Financial Services
KPMG
T: +44 20 7311 5800
E: jeremy.anderson@kpmg.co.uk

Gary Reader
**Global Head of Insurance and
EMA Coordinating Partner**
KPMG in the UK
T: +44 20 7694 4040
E: gary.reader@kpmg.co.uk

Laura Hay
**Americas Coordinating Insurance
Partner**
KPMG in the US
T: +1 212 872 3383
E: ljhay@kpmg.com

Simon Donowho
**ASPAC Coordinating
Insurance Partner**
KPMG in China
T: +852 2826 7105
E: simon.donowho@kpmg.com

Rob Curtis
**Executive Director and
Global Insurance Regulatory Lead**
KPMG in Australia
T: +61 3 9838 4692
E: rcurtis1@kpmg.com.au

Robert Kasinow
**Director and Americas Insurance
Regulatory Lead**
KPMG in the United States
T: +1 973 912 4534
E: rkasinow@kpmg.com

Janine Hawes
**Director and European Insurance
Regulatory Lead**
KPMG in the UK
T: +44 20 7311 5261
E: janine.hawes@kpmg.co.uk

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