

# **INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS**



## **GUIDANCE PAPER ON THE TREATMENT OF NON-REGULATED ENTITIES IN GROUP-WIDE SUPERVISION**

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## Guidance paper on the treatment of non-regulated entities in group-wide supervision

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### 1. Introduction

#### *IAIS developments on group issues*

1. Since its inception in 1994, the IAIS has developed a number of principles, standards and guidance papers to help promote the development, globally, of well-regulated insurance markets, consistent with one of its objectives under the IAIS By-laws. A further objective of the IAIS under the By-laws is to contribute to broader stability of the financial system.

2. The IAIS Insurance Core Principles (ICPs) establish the fundamental requirement for supervision on a group-wide basis. ICP 17 states that “the supervisory authority supervises its insurers on a solo and a group-wide basis”. The IAIS *Principles on group-wide supervision* (the Principles) elaborate on the requirements of ICP 17, with the purpose of establishing an internationally acceptable framework that contributes to ensuring appropriate streamlining, consistency, effectiveness and efficiency of supervision on a group-wide basis.

3. The IAIS *Multilateral Memorandum of Understanding on Cooperation and Information Exchange* (IAIS MMoU) establishes a formal basis for cross-border cooperation and information exchange among supervisors, and hence covers the circumstances of supervision at group level.

4. The IAIS *Guidance paper on the role and responsibilities of a group-wide supervisor* and the *Guidance paper on the use of a supervisory college in group-wide supervision* support the Principles, and provide guidance on possible elements of an international framework for group-wide supervision – the designation of a group-wide supervisor to promote effective and coordinated group-wide supervision and the

establishment of supervisory colleges to facilitate enhanced cooperation and information exchange between involved supervisors.

5. This guidance paper further complements this suite of papers on group-wide supervision. It considers the scope of group-wide supervision and in particular the supervisory approaches to non-regulated entities – whether non-operating holding companies (NOHCs) or non-regulated operating entities (NROEs) – within the insurance group or financial conglomerate. It is recognised that non-regulated entities within and/or connected with the other prudentially regulated non-insurance financial groups are, in principle, the subject of regulations of the other financial sectors. This guidance paper does not directly address the treatment of cross-sector entities or groups within an insurance group but it does recognise a need for insurance supervisors to assess risks to an insurance group from links to cross-sector entities and where necessary to take measures to mitigate those risks.

#### *International developments in relation to financial stability issues*

6. The insurance industry has been growing in complexity, diversity and global reach. Financial innovation and the rapidly changing financial environment have contributed to the formation of a variety of insurance entities and groups spanning across jurisdictional borders and/or sectors. This may include non-regulated entities, such as special purpose entities (SPEs) that may be established for multiple reasons. While there could be benefits from the formation of non-regulated entities, this can also bring an increased complexity due to the greater inter-connectedness within the insurance sector as well as the broader financial sector. As such, it is important to ensure that regulatory and supervisory tools and reach continue to keep pace with these institutional and structural developments in particular given the significance in relation to financial stability of such inter-connected entities.

7. In the light of the financial market crisis which commenced in mid 2007, there has been an increased focus on issues of financial stability, and the risks associated with large and complex financial organisations operating on a cross-border and/or cross-sector basis.

8. In the recommendations of the Financial Stability Forum (now the Financial Stability Board - FSB) in April 2008 and the statements of the G20 (November 2008<sup>1</sup>) – there has been particular reference to the importance of supervising the whole group, taking into account all risks from all entities within the group which may impact the financial position of the group. Further, the need to avoid gaps in regulation and supervision and/or potential for regulatory arbitrage has been clearly identified.

9. It is recognised that these issues require an international focus and extend beyond the insurance sector to include other financial sector regulators such as banking and securities regulators. Recent developments have been allowed for in the drafting of this paper with regards to the expectations and responsiveness on all international standard setters. As an active member of the FSB, the IAIS provides this guidance paper to enhance the supervision of non-regulated entities within and/or connected with an insurance group and hence contributing to the minimisation of regulatory gaps and arbitrage.

10. Consideration has also been given to the important work of the Joint Forum, at the request of the FSB, in this area – the workstream on differentiated nature and scope

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<sup>1</sup> The G20 declaration from November 2008 states: “The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently non-regulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken.”

of financial regulation<sup>2</sup>. There has been close coordination between the IAIS and the Joint Forum working group responsible for this workstream which enabled cross-fertilisation of ideas as both workstreams were developed in parallel. This guidance paper is also consistent with the recommendations contained in the Joint Forum Report on Special Purpose Entities<sup>3</sup>.

11. To inform the development of this guidance paper, the IGSC undertook a survey amongst its members on the supervisory approaches to the treatment of non-regulated entities and these are elaborated further in Section 4. The survey revealed several issues in extending the scope of group-wide supervision to non-regulated entities such as cross-border supervisory cooperation, legal powers, application of prudential requirements to non-financial activities and limitations of ring-fencing. However, the survey also highlighted regulatory gaps observed from the financial crisis such as cross-sectoral and cross-border regulatory arbitrage opportunities, enforcement of regulatory requirements on a cross-border basis, complexity of group structures and implementation of a risk-based group-wide supervisory framework.

#### *Scope and Purpose of the Paper*

12. Consistent with the identified scope of the Principles, the groups covered by this paper are those whose main activity is insurance, including reinsurance groups and insurance subgroups within a financial conglomerate<sup>4</sup>.

13. The purpose of this paper is to encourage the establishment, within the supervisory regime of a jurisdiction, of sufficient supervisory power and authority to ensure that supervision has proper regard to all entities which may affect the overall risk profile and/or financial position of the group as a whole and/or the individual entities within the group. Another objective of the paper is to promote greater consistency between jurisdictions. Section 4 describes the various approaches on how to achieve this objective including the circumstances in which an approach may be suitable.

14. In the case of entities which fall within the scope of supervision of other sectoral prudential supervisors, this paper takes as a starting point an assumption that the sectoral supervision by those prudential supervisors adequately addresses risk to the insurance group from those entities. However, insurance supervisors have a responsibility to consider the alignment of their own jurisdictional requirements against those of these other relevant supervisors. If sectoral supervision was found to be misaligned or sectoral supervisors did not include particular entities in the scope of their group supervision, then insurance supervisors should take steps to mitigate any risks to the insurance entities in the group.

15. In many jurisdictions, there may be non-prudential supervisors of entities within the insurance group (e.g. market conduct supervisors). It is important that they are communicated with to assess whether any elements of their assessment of the group or entities within the group need to be taken account of by the insurance supervisor.

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<sup>2</sup> The report can be downloaded from [http://www.iaisweb.org/\\_temp/Review\\_of\\_the\\_Differentiated\\_Nature\\_and\\_Scope\\_of\\_Financial\\_Regulation\\_January\\_2010.pdf](http://www.iaisweb.org/_temp/Review_of_the_Differentiated_Nature_and_Scope_of_Financial_Regulation_January_2010.pdf).

<sup>3</sup> The report can be downloaded from [http://www.iaisweb.org/\\_temp/Joint\\_Forum\\_Report\\_on\\_Special\\_Purpose\\_Entities\\_29\\_September\\_2009.pdf](http://www.iaisweb.org/_temp/Joint_Forum_Report_on_Special_Purpose_Entities_29_September_2009.pdf).

<sup>4</sup> While not directly within the scope of this paper, the IAIS acknowledges the relevance of financial conglomerates and the importance of considering mechanisms for supervisory communication and coordination on a cross-sectoral basis.

## 2. Types of non-regulated entities

16. For the purposes of this paper, two main types of non-regulated entities are distinguished:

- Non-operating holding companies (NOHCs); and
- Operating entities which are not subject to any form of direct prudential supervision (non-regulated operating entities or NROEs).

It is recognised that within these broad categorisations there may be different forms of non-regulated entity within the group. Further, the non-regulated entity may occur at various levels within the group structure and with varying degrees of direct relationship (either management or financial) with the insurance entities in the group.

17. In the case of NOHCs, the NOHC may be positioned at the top of a group structure, it may be at the top of an insurance subgroup within a larger group structure (including a financial conglomerate) or it may be at an intermediate level within the group. A group may have more than one NOHC at various levels within the group structure, including, as another example, a NOHC over a subgroup which contains only NROEs.

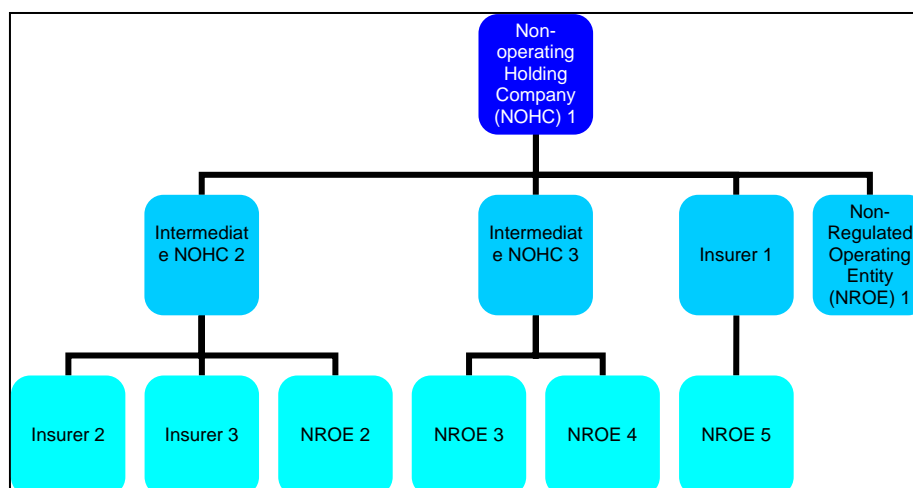
18. In the case of NROEs, again they may occur at various levels within the group structure. The NROE may be an entity directly located within the insurance group or subgroup (that is, under the line of control of the insurance parent company or the NOHC of the insurance group). Alternatively the NROE may only be less directly related to the insurance group, as an entity located in other subgroup within the group and/or under the line of control of a different NOHC.

19. As an example, figure 1 below illustrates the potential complexity of group structures, and the variety of locations of both NOHCs and NROEs within a group which may occur in practice.

20. The form of operations which a NROE may undertake can also vary widely. The operations may be financial in nature, they may be businesses ancillary to the financial operations of the group (for example outsourced administrative services in relation to the insurance business) or they may be totally unrelated to financial business (for example, a retail business). In the case of the latter, it is not the intention to suggest that such entities are brought into the supervisory framework, but it is important to give due regard to any risks these entities may pose to the operations, be they financial or otherwise, of the group.

21. It is recognised that a holding company, whether at the top of or intermediate within the group structure, may be an operating entity (rather than a NOHC) and could itself be a non-regulated operating entity.

Figure 1: Illustrative example of types of non-regulated entities



22. In large and more complex groups, it is likely that the operations of the group will extend both across jurisdictional borders and across sectors. This brings added complexities in terms of the supervision of the group and considerations of appropriately extending supervisory power and authority to all entities within the group must necessarily have regard to the legal limitations or challenges which may exist on a cross-jurisdictional basis and the challenges of differential regulation or supervision which may prevail on a cross-sectoral basis.

23. In establishing a group-wide supervision framework, regard should be had to including appropriate mechanisms to provide for the adequate supervisory treatment of non-regulated entities. Where non-regulated entities exist within a group, the supervision of that group would be enhanced where the framework for group-wide supervision includes one or more of the following features:

- appropriate supervisory reporting and disclosure requirements to facilitate adequate transparency of group structures and operations, allowing supervisors to establish a sound understanding of the group structure and linkages between entities within the group
- well-established mechanisms of supervisory cooperation and coordination and information exchange – at both cross-jurisdiction and cross-sector levels.

24. In the case of internationally active groups and/or financial conglomerates that are of a complex nature, a group-wide supervision framework should consider additional mechanisms that are commensurate with the nature, scale and complexity of the risks of the group in order to facilitate effective group-wide supervision. For example, the supervisory regime could implement additional mechanisms to ensure sufficient consideration of the corporate governance, risk management and internal control systems. In addition, the supervisory regime should require greater transparency within the group structure and ensure that those directors and executives in particular whose positions reflect group-wide responsibilities demonstrate that they are able to understand, manage and govern the organisation properly, in spite of its complexity. Greater cross-border and cross-sector cooperation would also assist supervisors to enhance their understanding of the complexity of the group.

### **3. Risks to a group from non-regulated entities**

25. There are several risks that may arise from the existence of non-regulated entities within and/or connected with an insurance group or a financial conglomerate.

26. The financial crisis which commenced in 2007 provided us with striking examples where the existence of NOHCs or NROEs had negative effects on insurance groups as a whole. For example, the case of the American International Group (AIG) may be used as an example of how an operating but non-regulated entity can lead to the breakdown of a financial conglomerate<sup>5</sup>.

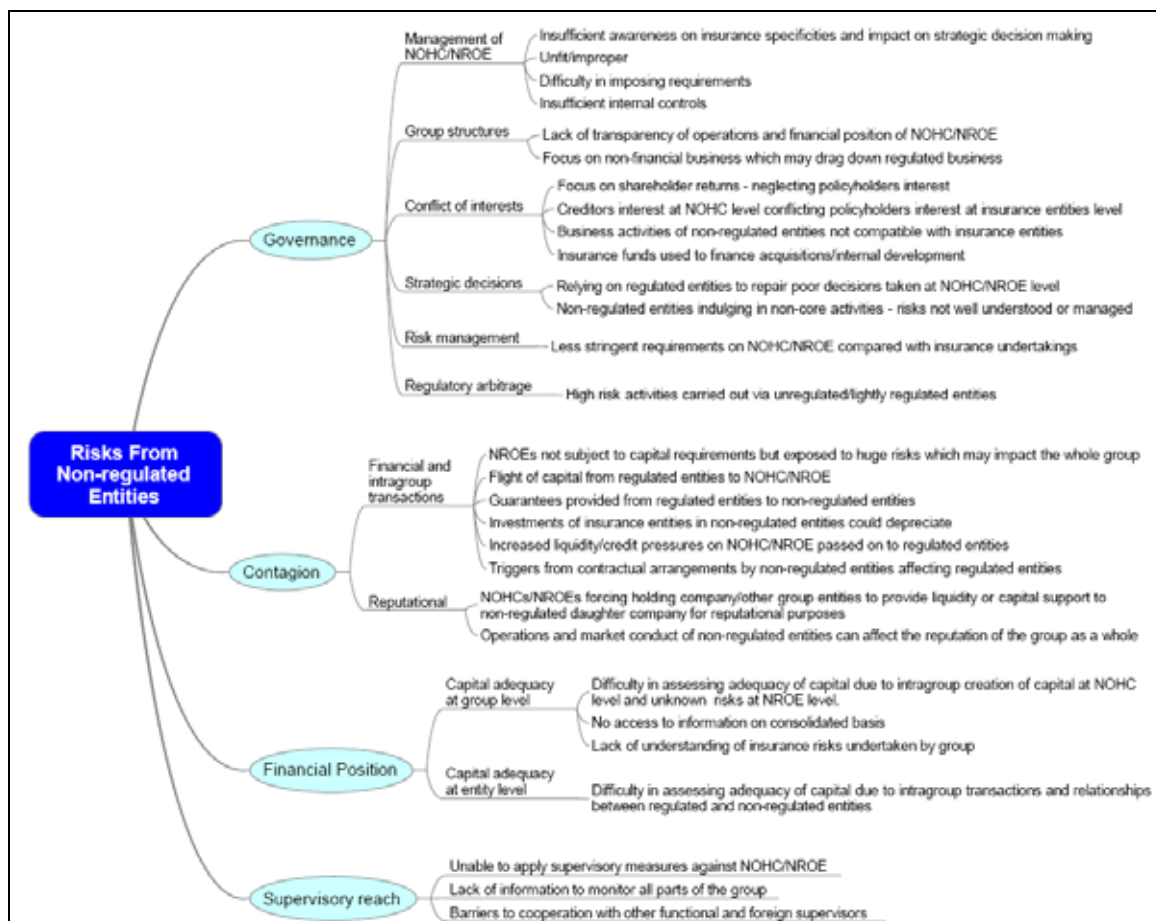
27. For the purposes of this paper, four main areas for which non-regulated entities could pose major sources of risks are contagion effects, financial position, governance, and supervisory reach.

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<sup>5</sup> Refer to Annex I for a case study based on the AIG example, and discussion of the supervisory lessons learnt in this context.

28. Consistent with a risk-based approach to supervision, it is important that a group-wide supervision framework has regard for all risks which may affect the risk profile and/or financial position of the group and/or the individual entities within the group. In particular, supervision should be extended to have regard for the sources of risk to the group from any non-regulated entities within and/or connected with the group.

Figure 2: Risks from non-regulated entities



### 3.1 Governance

29. Many aspects of the governance of an insurance group can be affected by the increased complexity arising from the presence of non-regulated entities within and/or connected with the group, be they NOHCs or NROEs.

*Insufficient awareness including on cross-sectoral matters by Directors and/or Executives and its impact on strategic decision making*

30. In the case of NOHCs and NROEs, it may be harder, if not impossible, in many jurisdictions to apply conduct of business supervisory measures and requirements such as fit and proper testing which are normally used for insurance companies. This could result in an unfit management running the strategic operations of the insurance group, if the NOHC is located at the top of the group. Management at the top NOHC level could also be unaware of, or not attentive to insurance sector specificities and risks.

31. Strategic decisions which are irrelevant to, or in contradiction with the core insurance activity could be taken at the NOHC level. As a result, the regulated entities

may be affected by poor management decisions or by the activities of the NROEs. It might be the case that the interaction between the risks taken at the NROE level and the insurance entities are not well understood or managed.

#### *Group structure: Lack of transparency and appropriate disclosures*

32. A lack of transparency of the group structure can make it difficult for supervisors, management, as well as other third parties (investors, rating agencies, policyholders) to get a comprehensive knowledge or understanding of the group and the risks it faces. It can be particularly difficult for insurance supervisors to assess the risk of an insurance group as a whole if most of the risks are concentrated in non-regulated entities.

33. The issue of lack of transparency is more severe when overly complex operating structures are used involving a large number of legal entities especially when the entities are located in many different jurisdictions or operate in many different commercial sectors, or when intermediate holding companies are used, for example, to "create" intra-group capital or to make a follow-up approach harder to implement (see Section 4).

#### *Conflicts of interest*

34. Conflicts of interest might occur in many ways within a group structure even if the different parts of the group and the NOHC have a common management. Even if there are no individuals who sit in multiple management structures, there can be a lack of independence at the subsidiary level if the management feels unable to challenge the decisions made at the NOHC level. Moreover, the interests of the insurance entities might not be in line with the interests of the NOHC or of the other operating entities (both regulated and non-regulated). For example:

- different locations of stakeholders within the group (shareholders at the top level, policyholders at subsidiary level, creditors at top or subsidiary level) may present conflict of interest to the detriment of stakeholders at the entity level – for example, the NOHC may ask for more dividends to be distributed by the insurance entity or for the insurance entity to 'upstream' surplus capital;
- creditors' interests at the NOHC level may be in conflict with policyholders' interests at the insurance entities level, as some of the debt instruments issued by the NOHC can benefit from credit enhancement through credit insurance provided by one of the insurance entities of the group which will, in case of financial distress, give creditors the same rights as the other policyholders;
- the business activity of non-regulated entities may be compatible with the insurance entity but benefit from some regulatory arbitrage (e.g. traditional bond insurance vs. other forms of credit enhancement);
- strategic decisions, such as aggressive expansions or broad capital management initiatives, are likely to be taken at group level. These could result in insurance entities' funds being used to finance acquisitions or internal development of the group through intra-group transactions and exposures.

#### *Risk management*

35. If large parts of the risk management function are located at the NOHC level, it could be the case that the requirements on risk management are less stringent at that level than at the individual insurance entity level. A centralised risk management at group level could also be unaware of the specificities of some entities.

36. The risk culture may be different between the regulated and non-regulated parts of the group. This might include differences in the treatment of complex financial products or in terms of a higher risk tolerance in general.

37. In addition to the issue of governance and cultural differences between entities within a group, there could be an issue of conflict of priorities between the different entities – where limited resources (financial, skills or other resources) within a group have to be allocated according to some priorities between the entities within that group.

#### *Regulatory arbitrage*

38. In recent times, regulatory arbitrage opportunities and the potential for gaps between jurisdictions have become more evident. The increased significance of this issue has not only been identified by national authorities but also international bodies such as the G20 and the FSB. NOHCs as well as NROEs may be used to engage in activities within the group that would otherwise not be allowed in an insurer, and which could endanger the financial safety of the insurer. These activities may even have contagion effects on the regulated entities (refer to Section 3.2 below).

39. Opportunities for regulatory arbitrage may also create risks if, for example, entities are set up in jurisdictions or sectors with a lower level of regulation and supervision whereby activities are allowed that would not otherwise be permitted or would incur significant higher capital requirements, in the home jurisdiction. Also, the quality of supervision and supervisory resources may, in some cases, not be equivalent or adequate.

### **3.2 Contagion effects: financial contagion and reputational risk**

#### *Financial contagion and intra-group transactions and exposures*

40. A major risk in insurance groups or financial conglomerates, in general, comes from financial contagion effects: risk exposure or operations within one part of a group could negatively affect other parts of, or the whole group.

41. In the context of insurance supervision, the activities of a NOHC or a NROE could negatively affect an insurance entity within the insurance group or financial conglomerate. For example, NROEs may be exposed to huge risks without proper capital requirements due to the fact that they are outside the scope of supervision even though the materialisation of these risks could have severe consequences for the whole group (NOHC and insurance entities). Large amounts of debts or other liabilities (including off-balance sheet guarantees) could also be taken at the NOHC level which may result in the NOHC needing more capital from the insurance entities and being eventually unable to provide the insurance entities with financial support when needed.

42. Insurance entities within the group can be directly exposed to these non-regulated entities' operations and risks through intra-group transactions and exposures, such as:

- Agreements in place with NOHCs that require insurance entities to pass on specified levels of dividends or capital to the NOHC;
- Guarantees, whether implicit or explicit, provided to non-regulated entities (such as credit enhancement, swap agreements, etc.) that can trigger financial transactions between the different entities;
- Insurance entities' investments in non-regulated entities (shares, subordinated debt securities, loans, etc.) could significantly depreciate.

### *Reputational risk*

43. Reputational risk may arise from the dealings of a non-regulated entity if these actions negatively affect the reputation of the insurance group regardless of whether the regulated parts were responsible for these actions or not. Reputational risk may also arise from the condition of the financial sector if parts of it, or the whole sector, suffer from adverse reputation or bad public perception.

44. For example, if a NOHC is under financial stress, the policyholders of an insurance company below the NOHC may seek to surrender their policies as they may fear that the insurance entity would not be able to fulfil its obligations. The severe period of stress that occurred in October 2008 showed some of these effects, resulting in higher surrender rates even for financially sound insurance entities. Such behaviour can then place insurers under liquidity stress and thus could exacerbate further their financial stress.

45. Reputational risk could also arise when a NROE engages in too risky or unethical business activities which could compromise the reputation of the group as a whole.

### **3.3 Financial Position**

#### *Capital adequacy at group level*

46. It can be difficult for the management, supervisors, or other stakeholders, to assess the capital adequacy at the group level (due to possible intra-group creation of capital at NOHC level, or unknown risks being taken at NROE level).

47. It can be particularly difficult for supervisors to obtain information needed to monitor the non-regulated entity appropriately (see Section 3.4 below). Without sufficient information, supervisors might not have a comprehensive understanding of the activities undertaken at the non-regulated entity level and the associated risks. Uneven distribution of capital between the NOHCs and the operating entities might not be detected. Overall, there may be risks associated with the inability to consolidate information on capital adequacy matters due to, for example, missing information on intra-group transactions and exposures, missing information on multiple gearing etc.

48. The structure of a NOHC or a NROE may make it difficult for supervisors to consolidate this information and to take it into account in the calculation of group solvency requirements.

49. Risk exposure and sensitivity to specific markets at the group level could also be difficult to assess due to missing information on intra-group transactions and exposures of non-regulated entities: for instance, insurance entities could hedge against a fall in stock index by buying put options on the index, while non-regulated entities could, on the contrary, have massively sold such put options betting on a rise in the stock market, which would leave the group as a whole significantly exposed to a decrease of the index.

#### *Capital adequacy at entity level*

50. The presence of intra-group transactions and exposures and other relationships between both regulated and non-regulated entities could also make it difficult for supervisors and third parties to assess the adequacy of capital at entity level, as intermediate NOHC could, for instance hide intra-group creation of capital.

### **3.4 Supervisory Reach**

#### *Application of supervisory measures*

51. As non-regulated entities are not directly supervised or regulated, it is also very difficult to apply supervisory measures on such entities. As an example, most supervisors are not able to require NOHCs to be licensed. Ensuring fit and proper requirements are met is another example where the application of supervisory measures would be difficult, as described in section 3.1.

#### *Problems in obtaining information and not being able to monitor all parts of a group appropriately*

52. As has already been noted, NOHCs and NROEs are not subject to the same reporting requirements as regulated insurance entities, which may make it harder for supervisors to obtain appropriate, reliable and timely information. This may hinder appropriate monitoring of all parts of the group.

#### *Cooperation with other supervisors*

53. Certain parts of a group as well as NOHCs and NROEs may be located outside the jurisdiction of the home supervisor. At times, the access to, or awareness of, information that is of a material nature to a group's operations may only be available through interaction with other supervisors who are able to access such information via their supervisory requirements. Close cooperation with the relevant jurisdiction(s) is very important under these circumstances.

54. Cross-border and cross-sector cooperation and exchange of information is therefore critical for effective group-wide supervision.

## **4. Approaches to supervision of non-regulated entities**

55. A survey among jurisdictions that have significant presence of large insurance groups or conglomerates has helped to identify the main approaches to the supervision of non-regulated entities. The first two approaches have been classified as direct and indirect to most accurately reflect the methods and instruments used by the majority of supervisors both from a solo level and also allowing for non-regulated entities in the context of group-wide supervision. Hybrid approaches, combining aspects of the direct and indirect approaches, have also been observed. In addition, in some cases it may not be practical to include a non-regulated entity within the scope of group-wide supervision or to obtain timely and reliable information about these entities. In this case, ring-fencing or other mitigation measures may be appropriate and have also been briefly summarised.

56. This section describes the main approaches and assesses their benefits and disadvantages for NOHCs and, separately, NROEs, taking into account the risks relating to each type of non-regulated entity as identified in section 3 of this paper, and the type of regulatory requirement needed to address such risks.

57. Also outlined are examples of three particular jurisdictions that demonstrate to a degree the direct, indirect and hybrid approaches that have been identified<sup>6</sup>. The following jurisdictions are intended to be examples only and it should be recognised that further variations to these approaches by other jurisdictions is occurring.

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<sup>6</sup> To outline further the comparison on a cross-sector basis, the Basel II approach has been highlighted in Annex II.

## 4.1 Direct Approach

58. The direct approach entails the licensing or authorisation of insurance group entities which do not themselves provide insurance services (e.g. NOHCs or NROEs). Potentially this would make available a full range of supervisory powers including:

- reporting requirements
- capital/proxy capital requirements at solo and/or consolidated level
- governance and risk management requirements
- onsite inspection
- pre-approval/ licensing requirements
- enforcement and intervention powers.

59. In essence, the direct approach enables supervisors the opportunity to extend the existing remit required by the local operating entities licensed within their jurisdictions. Such extension would typically include the assessment of capital, risk landscape and corporate governance standards, to also apply at the holding level.

60. The direct approach at a group level and as a standalone form of supervision was not evidenced in practice, although a number of jurisdictions apply it in conjunction with non-direct methods (refer hybrid approach below) or plan to apply it in respect of NOHCs.

### ***Australia - an example of direct approach for NOHC***

While often described as a direct approach, the Australian regime is a combination of both direct and indirect approaches (the latter being very similar to the hybrid approach described below for Switzerland).

Australian law was changed to provide for the authorisation of NOHCs and in 2002 APRA authorised those for the main Australian non-life insurers<sup>7</sup>. The authorisation of the NOHC gives APRA the power to access Board minutes and papers at the NOHC level - which is where many of group decisions on matters such as capital management, acquisitions and business strategies are made.

When 'behavioural standards' such as governance and fit and proper were introduced by APRA in 2006, these were applied to both individual authorised insurers and to authorised NOHCs. This ensures that not only are there appropriate controls in these important areas at the authorised insurer level but these same controls apply at the level of the NOHC and therefore, by implication, the entire group. Thus at the level of the NOHC there is direct regulation and supervision.

From 2009, APRA has introduced capital requirements for non-life insurance groups which are defined as either:

- (a) if an insurer is not a subsidiary of an authorised NOHC and the insurer has subsidiaries, the consolidation of the insurer and all its subsidiary entities other than non-consolidated subsidiaries; or
- (b) the consolidation of an authorised NOHC and all the authorised NOHC's subsidiary entities (including any insurers and their subsidiary entities other than non-consolidated subsidiaries).

Thus while the regulation of NOHCs is a 'direct' approach – although it does not include a capital requirement for the NOHC itself - the regulation of other non-regulated

<sup>7</sup> Legislative powers to authorise NOHCs for life insurers were only passed in 2009.

subsidiaries remains indirect and from a capital perspective the non-regulated entities are accounted for by this consolidation process. However, the consolidation process does give APRA effective direct regulatory and supervisory reach over the group as a whole albeit not over each individual NROE.

## 4.2 Indirect Approach

61. The indirect approach relies on exercise of supervisory powers through a regulated entity in the group, and as part of the supervision of that entity. Depending on its nature, a non-regulated entity may be within the perimeter of group-wide supervision or outside it. In the case of the former, indirect supervision may provide:

- access to information via the parent or other regulated group entities about activities within the group involving non-regulated entities (intra-group transactions but probably not exposures outside the group via non-regulated entities)
- depending on the type of non-regulated entity:
  - consolidation/aggregation approaches to group capital adequacy
  - fit and proper requirements on directors & managers
  - limited rights of inspection and intervention powers.

62. In the case of non-regulated entities outside the perimeter of group supervision, the indirect approach to supervision is generally limited to exclusion of non-regulated entities by deduction of capital investment and limits on exposures to those entities by group entities which are inside the perimeter of group supervision.

63. Indirect approaches to supervision of non-regulated entities were found to be more common in practice.

### ***United Kingdom – an example of indirect approach***

In the UK, in common with other EU jurisdictions, supervision of insurance groups is based on provisions of the European Insurance Groups Directive. The directive requires that insurance holding companies (NOHCs in the context of this paper) are taken into account in the assessment of group capital adequacy and supervision of intra-group transactions and exposures and persons who effectively direct the business of an insurance holding company must be of sufficiently good repute and have sufficient experience to perform these duties. In addition the Financial Conglomerates Directive requires that NOHCs and some other financial entities, including some non-regulated operating financial institutions (which come under the description of NROEs in the context of this paper), are taken into account in supervision of group solvency, intra-group transactions and exposures, group level risk concentrations and internal controls and risk management processes of financial conglomerates. The directives are silent regarding a direct or indirect approach to the supervision of such non-regulated entities – the EU jurisdictions may therefore follow different approaches.

The UK has adopted an indirect approach to the supervision of non-regulated entities. Regulated insurance companies within a group are required to comply with group level requirements regarding solvency, fit and properness, intra-group transactions and exposures, internal controls and risk management processes. In practice this means that NOHCs are taken into account in the group level requirements applied to regulated insurance companies. It also means that some NROEs are taken into account in group level solvency requirements and for the purpose of supervising intra-group transactions

and exposures of regulated insurance companies within a group. Supervision does not extend to transactions undertaken by those NROEs or fit and properness of their management. Other NROEs would normally be deducted for group solvency purposes and exposures of regulated insurance companies within the group to those NROEs are monitored and potentially limited.

### **4.3 Hybrid Approaches**

64. In addition to the two main approaches described above, some jurisdictions were found to operate hybrid approaches which mix different combinations of direct and indirect approaches for different aspects of supervision. This may entail a direct licensing requirement without a full range of direct supervisory powers or an indirect approach with some limited direct supervisory powers in certain cases. Like the direct approach, licensing of the parent entity may be required but includes as well the use of indirect approaches at the parent level, in order to capture the specific profile of the organisation as a group<sup>8</sup>.

#### ***Switzerland – an example of the Hybrid approach***

Swiss law has been extended insofar as to set specific criteria, which if met, may see the parent entity also placed under supervision. Although not licensed itself, the parent entity is required to directly comply with several group specific legal requirements which look at the group from a comprehensive yet focussed view. These require that the assessment of capital adequacy is taken into account from the group level as well as demonstrating fit and proper governance standards as well as sufficient internal control and risk management systems throughout the group are in force. The Directives extend further such that NOHCs and also NROEs, are taken into account in the supervision of group solvency, intra-group transactions and exposures, group level risk concentrations, internal controls, risk management processes as well as specific group reporting. This operates simultaneously with, but does not supersede or replace, requirements placed upon the solo entity.

Whilst additional reporting requirements are placed directly on the group, Switzerland also follows to a degree an approach where the company must also present its group wide reporting requirements to an external auditor for examination. In this regard intra-group transactions and exposures of a material nature are captured.

### **4.4. Ring-fencing**

65. In some cases it may not be practical to include a non-regulated entity under any of the approaches discussed above. This may be the case where relevant information about an entity is not available or where it is not practical to impose direct or indirect capital or other requirements on such entities. In these circumstances the financial risks to the group can be partially addressed by deducting from group capital adequacy the value of the group's interest in those entities whilst on the other hand imposition of direct limits on exposures can be used. However it should be recognised that ring-fencing may not isolate insurance entities from all contagion risks (e.g. reputation risk). Therefore insurance supervisors should make every effort to gather information on all non-regulated group entities.

<sup>8</sup> Application of a direct approach for NOHCs and an indirect approach for NROE is not considered to be a hybrid approach.

#### **4.5 Advantages and disadvantages of the different approaches for NOHCs and, separately, NROEs**

##### *Direct approach for NOHCs*

66. Direct authorisation or licensing of NOHCs may address many of the risks identified in section 3. In cases where governance, strategic direction and senior management are concentrated in the top NOHC, direct application of fit and properness requirements as well as internal control and risk management requirements would normally be easier and more effective than under an indirect approach. In addition, access to information and on-site inspection would be enhanced, particularly in complex structures involving intermediate holding companies which head up subgroups and especially if located in other jurisdictions. A direct approach may also facilitate supervisory actions and enforcement.

67. On the other hand, a direct approach for NOHCs may not have a clear advantage over an indirect approach in other areas of risk. In particular, inclusion of NOHCs in the assessment of group capital adequacy may just as easily be achieved under an indirect approach. Also NOHCs by definition are not operating entities (although some holding companies may undertake some, non-insurance, activities, including funding and intra-group transactions and exposures) so the need for direct information and other supervisory requirements may, arguably, be less extensive.

68. A difficulty in the correct implementation of a direct approach for NOHCs may also come from regulatory arbitrage from insurance groups who can choose to incorporate their holding companies in other countries where they are not subject to such requirements. The jurisdictions involved would then be expected to cooperate to allow supervisors of the regulated entities to have access to all information needed. There may also be potential legal difficulties in establishing powers to license entities which do not provide insurance services.

##### *Direct approach for NROEs*

69. A direct approach to supervision of NROEs is potentially more effective for supervision of all aspects of risk that such entities may pose to an insurance group and its component entities. Potentially, NROEs can create a wider range of risks than NOHCs since, as operational entities, they can take on and manage risk themselves. However there are significant difficulties with a direct approach.

70. Firstly it will be necessary to distinguish between different types of NROEs in order to assess the risks they pose and design the appropriate regulatory tools to address those risks. Typically a direct approach would not be expected for non-regulated entities operating in a non-financial field.

71. Secondly bringing one type of NROE under direct prudential supervision would risk the market creating another form of disintermediation with the result that the regulatory perimeter shifts but does not resolve the regulatory gap. Regulatory arbitrage with less stringent jurisdictions will be a factor.

72. Other disadvantages of a direct approach to the supervision of NROEs include:

- significant extra regulatory burden for both supervisors and supervised
- practicality of extending prudential requirements to some activities
- need for additional supervisory resources, expertise and legal power to extend the perimeter of direct supervision.

### *Indirect approach for NOHCs*

73. An important advantage of an indirect approach to supervision of NOHCs (and NROEs) is that it can operate within the existing scope of regulations and would therefore not need any additional legal powers.

74. As far as group solvency is concerned, NOHCs can be included within the regulatory perimeter without the need for direct licensing. Non-operating companies generally do not attract capital requirements. However, NOHCs can be included for the purposes of the capital calculation in order to address double gearing and leveraging of the quality of capital.

75. An indirect approach may be not so well suited for supervising governance, internal controls, risk management processes and intra-group transactions and exposures, particularly where strategic decisions regarding these areas are concentrated in the top NOHC. Nevertheless indirect approaches have been shown to work in these circumstances although problems may be experienced in more complex groups where intermediate NOHCs are established at the top of subgroups, especially in overseas jurisdictions.

### *Indirect approach for NROEs*

76. For certain NROEs which undertake activities related to the insurance activities of the group or other relevant financial activities (e.g. in the context of EU directives “financial institutions”, “ancillary services undertakings”, “insurance special purpose vehicles”) an indirect approach can operate within the existing scope of regulation by including such entities within the perimeter of group-wide supervision. This would include some NROEs in the group solvency assessment although a complicating factor may be the need to establish and apply proxy capital requirements. It may also be considered inappropriate to recognise surpluses in such entities for the purpose of group solvency. As with NOHCs, an indirect approach may be less well suited to some other risk management type requirements and would not allow any direct supervisory control over the activities of NROEs. A key issue is therefore access to sufficient and timely information on those activities, the relationship between regulated and non-regulated group entities and if necessary suitable protection for regulated members (e.g. exposure limits).

77. However it may not be possible or appropriate to bring some other NROEs within the perimeter of group-wide supervision. In this case the only alternative may be a ring-fencing regime but complexity of group structures and residual contagion risks may make effective ring-fencing difficult to achieve. New powers to gather information may therefore be needed to develop greater understanding of group structures and increase knowledge of the relative importance and purpose of non-regulated entities to groups.

### *Hybrid approach*

78. Given the wide range of types of non-regulated entity, a hybrid approach mixing direct and indirect approaches may also be an appropriate alternative. This may be based in the first instance on enhanced information gathering powers so that particular intra-group relationship can be better analysed and direct supervisory power introduced where needed on a case-by-case basis. Review of the capital adequacy requirements from a consolidated level coupled with group-wide reporting on intra-group transactions and exposures, corporate governance, internal control systems and risk management may be able to assist supervisors to get a better grasp of the whole entity.

## 5. Key Features of Effective Treatment of Non-regulated Entities in Group-wide Supervision

79. While, as seen above, different approaches to group-wide supervision and to the treatment of non-regulated entities exist in practice depending on local legal system, supervisory power, and types of non-regulated entities, appropriate supervisory treatment of such entities would be expected to share important characteristics and outcomes critical to an effective group-wide supervision.

### *A comprehensive group-wide supervisory approach*

#### **Key Feature 1<sup>9</sup>**

A group-wide supervision framework should allow for a comprehensive understanding of the group, having due regard to the complexity of organisational structures of insurance groups and to all risks arising from the wider group which may affect the risk profile and/or financial position of the insurance group and/or the individual entities within the insurance group.

80. An appropriate supervision of insurance entities within an insurance group and of the insurance group in its entirety is only possible when the supervisors have a comprehensive understanding of the group as whole, including its non-regulated entities.

81. In particular, the operations conducted by the NROE within the group should be well understood by insurance supervisors, and the risks borne from these activities should also be understood and assessed.

82. The organisational structure of the group should also be understood by supervisors, in particular when the group uses complex organisational structures, including many NOHCs at top or intermediate levels, in different jurisdictions. The organisation structure of a group should be such that supervisors are able to understand the rationale behind the choice of certain organisational structures and the consequences these choices can have on the effectiveness of supervision.

### *Assessment of regulated entities exposure to non-regulated entities*

#### **Key Feature 2**

Supervisors should understand and assess the sources of risk to the insurance group and regulated entities from any non-regulated entities within and/or connected with the group.

83. Once supervisors are able to understand the different activities, and risk exposure of the group as a whole posed by both non-regulated and regulated entities, they should also assess the exposure of regulated entities to both NOHCs and NROEs which may arise from intra-group transactions and exposures, and the impact non-regulated activities can have on the solvency position of the regulated entities.

<sup>9</sup> It should be noted that under ICP 6 Licensing, Essential Criteria j states that “The supervisory authority refuses to issue a licence where it considers the applicant not to have sufficient resources to maintain the insurer’s solvency on an on-going basis, where the organisational (or group) structure hinders effective supervision, or where the application is not in accordance with the licensing criteria.”; while Essential Criteria h describes that “The supervisory authority imposes additional requirements, conditions or restrictions on an applicant where the supervisory authority considers this appropriate. This might include restrictions on non-insurance activities.

**Key Feature 3**

Assessment of capital adequacy on a group-wide basis should have regard to risks arising from non-regulated entities.

84. The capital adequacy assessment of the group as a whole and of the insurance entities at entity level is expected to take into account the potential risk exposure from non-regulated entities.

85. Insurance supervisors should have regard to risks arising from non-regulated entities when setting appropriate capital requirements or limit the level of participation in non-regulated entities both at the solo and group levels. As an example, this may include not taking into account the participation in or loans to these entities in the calculation of the group or regulated entities' shareholders funds.

86. The assessment of adequate capital requirements needed for non-regulated entities can be a very difficult task for insurance supervisors, especially when the activities of a NROE are in a completely different field. For activities that have similar characteristics as insurance (e.g. certain credit enhancements mechanisms as compared with traditional bond insurance) but are conducted through non-regulated entities that could benefit from regulatory arbitrage, a possible requirement could be, when calculating the group capital adequacy, to impose the same capital requirements that would be imposed to these activities were they conducted through insurance contracts.

*Proper governance and internal control requirements*

**Key Feature 4**

Assessment of fitness and propriety of the board and senior management on a group-wide basis should have regard to the understanding of the board and senior management of the group of the overall group structure and business operations. Overall governance, risk management and internal controls of the group should match its group-wide risk profile and structure.

87. Groups are becoming increasingly complex in both nature and operation. If directors and executives intend to operate a complex structure, then they must be able to establish that they have a full understanding of the complete group organisational structure and financial and operational links, as well as the contagion effects that may occur between the different entities. Through this awareness and in spite of the complexity of the group, directors and executives should then be able to demonstrate that they are able to manage, and govern, the entire group properly.

88. An effective means by which directors can ensure the proper treatment of non-regulated entities within and/or connected with the group would be through the existence of robust corporate governance standards that accurately represent the group-wide profile. Requirements should then dictate that these match with the internal control and risk management framework of the whole enterprise and are able to manage the risks to regulated entities arising from its non-regulated activities.

89. Where supervisors believe that the quality of governance as well as the risk management and internal controls of the group do not match the group-wide risk profile and its structure, then the supervisor should consider further regulatory and supervisory mechanisms, including capital or other prudential requirements, taking into account the complexity of both the group's operations and structure.

**Key Feature 5**

Appropriate supervisory reporting and disclosure requirements should be established to allow for adequate transparency of group structures and operations.

90. When not using a direct approach on NOHCs and NROEs, supervisors have to make sure they get timely, appropriate and reliable information on the activities and risk exposure of non-regulated entities. Timely information is especially needed for the non-regulated entities that operate in highly leveraged financial sectors, as their financial positions and risk exposure can vary rapidly and cause severe stress on the group's financial position as seen during the financial crisis that began in 2007.

91. It can be difficult for the supervisor to obtain such timely, appropriate and reliable information for many reasons, for example:

- The insurance entities' management could have no access to this information (for instance, because the NOHC or the NROE is not a direct affiliate of the insurance entity, or because the management of these non-regulated entities is not cooperative)
- The insurance entities' management could be unable to properly understand and assess the risks and activities of non-regulated entities
- The insurance entities could inadvertently limit or manipulate the information sent to the supervisors.

92. In such instances, supervisors should have sufficient legal power and supervisory authority to take additional measures in order to offset any material risks that may arise due to the insufficient disclosures.

*International cooperation and information exchange*

**Key Feature 6**

For effective supervisory treatment of non-regulated entities, supervisors should cooperate, coordinate and exchange information on both a cross-border and cross-sector basis. Enhancement of cooperation should also exist in the harmonisation of cross-border and cross-sector supervision.

93. International cooperation and exchange of information is critical to a successful group-wide supervision for cross-border insurance groups. In particular when non-regulated entities are located in another jurisdiction, the supervisors and jurisdictions involved would be expected to cooperate to allow the regulated entities' supervisors to have adequate access to information and undertake the necessary actions while respecting national laws.

94. In the event that a supervisor does not have direct access to information on non-regulated entities that may be material to the effective supervision of the group, then liaison with other supervisors who through the use of indirect, follow-up or other methods are able to gain access should be considered, subject to the necessary information sharing and confidentiality requirements if any apply. Alternatively, when an insurance supervisor has access to substantial information on non-regulated entities, or takes actions in order to ring-fence the insurance entities under his supervision from non-regulated entities activities, he should inform the other supervisors involved (from the insurance and other sectors) and cooperate with them to protect, to the extent possible, all policyholders of the group, for instance through colleges of supervisors.

*Flexibility and regular assessment of the scope of supervision*

**Key Feature 7**

The scope of the group-wide supervision framework should be flexible enough to capture emerging new risks from non-regulated entities.

95. It is probable that, whatever the scope of supervision is, new activities, markets and entities will develop on the edge of, or outside the scope of supervision. Any approach to non-regulated entities would then need to be flexible and pragmatic to ensure that the scope of supervision is always appropriate and regularly assessed. Supervisors, regulators, and international standard setters should always be aware of potential new risks which may arise from non-regulated activities, and how they may affect insurance entities and policyholders.

*Risk mitigation measures, including ring-fencing*

**Key Feature 8**

Risk mitigation measures should be considered as a possible option in the treatment of non-regulated entities. Such measures may involve ring-fencing.

96. An understanding and assessment of non-regulated entities activities and risks, or additional solvency requirements might not be sufficient to effectively protect policyholders, for instance when supervisors believe that the information they have on the non-regulated entities of the group may not be reliable or timely, due to one of the reasons mentioned above. This may not allow insurance supervisors to assess the insurance entities' risk exposure. Alternatively, the information gathered may indicate that risk exposure to the non-regulated entities threatens policyholders' protection significantly.

97. In these cases, insurance supervisors could, where legally possible, implement risk mitigation measures (such as forbidding distribution of dividends to holding companies, issuance of new guarantees, or new participations in these entities), and ring-fencing measures, such as portfolio transfers to a more remote insurance entity within the group.

## A perspective of what went wrong, the case of AIG

In 2008, AIG was a global financial conglomerate with significant insurance operations and operated in more than 130 countries and had about 116,000 employees. For the year 2007, AIG reported earnings of USD 6.2b. Its balance sheet amounted to more than USD 1 trillion and the group was the world's largest insurance group. AIG in 2009 provides us with a very different picture. AIG's total assets stood at USD 860b and its 2008 earnings were a record loss of USD 100b. In the fourth quarter of 2008 alone, AIG made a loss of USD 60b. Its stock fell from around USD 50 in the beginning of 2008 to around USD 1 in Mid-2009.

AIG was an extremely complex operation which had many subsidiaries and was basically able to choose its supervisor. Its consolidated supervisor is, thus, the Office of Thrift Supervision (OTS). AIG's problems did not originate in its insurance companies but instead at the holding level and its non-insurance subsidiaries, particularly AIG Financial Products.

The reputation and brand of AIG's well capitalised and highly rated insurance business were used to support its financial products trading business which specialised in the trading of Credit Default Swaps (CDSs). CDSs were, unlike insurance, not regulated and were traded over-the-counter<sup>10</sup>. AIG insured more than USD 500b of debt against default through the use of CDSs. They insured credit events on super-senior tranches of financial obligations (normally AAA or equivalent tranches). This includes asset backed securities (ABS). AIG Financial Products Corp. (AIGFP), based in London (UK), is a very small unit within AIG (about 400 employees). Counterparties include major banks, hedge funds, money managers, sovereign wealth funds and other institutional investors. At least some of them may have sought to buy protection from AIG in order to reduce their regulatory capital requirements. AIG did not expect the CDSs to be executed which probably were one of the motivations behind its massive use. Historical data did not indicate default levels high enough to seriously threaten AIG's business. The perceived risk seemed to be low and the unit contributed substantially to AIG's profits for some years. However, this strategy eventually appeared to be flawed and AIGFP amassed heavy losses in 2007 and 2008. A CDS portfolio of more than USD 60b on CDOs existed with Residential Mortgage Backed Securities (RMBS) as underlying assets including subprime mortgages. This caused write-downs but also made it necessary to post cash collateral as the CDOs reduced in value.<sup>11</sup>

Another issue AIG had to face arose from its securities lending programme. AIG's insurance undertakings essentially lent securities via this programme to other financial institutions outside the AIG group in exchange for cash collateral. This money was then used by AIG Investments for investments in RMBS and other debt obligations. Issues regarding mismatched maturities were already being addressed at the direction of US state insurance regulators, and the securities lending programs were significantly scaled back in scope, with the insurers increasing their cash holdings instead. With news on the weakening state of Lehman Brothers and as subprime mortgage loans began experiencing trouble, securities involved with those mortgage loans began to lose value. Analysts and rating agencies began considering these impacts in their assessments of companies. When the AIG Holding Company received a credit rating downgrade on September 16, 2008, it triggered collateral requirements for the multi-billion dollar security transactions it covered through the Financial Products Unit. The amount of these collateral requirements exceeded what AIG Holding Company could provide, resulting in

<sup>10</sup> IOSCO is currently addressing this issue.

<sup>11</sup> See William K. Sjostrom (2009): "The AIG Bailout", [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1346552](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552), last retrieved 24/03/2009.

a liquidity crisis. At this point the Federal Reserve had to determine whether AIG Holding Company should receive support or be left to fail. AIG Holding Company is a large and complex entity; and its failure would negatively impact most financial entities in the U.S. and many others throughout the world. Due to this systemic risk and given the economy's already struggling position, the Federal Reserve Bank of New York avoided the widespread negative impact of an AIG Holding Company failure by providing it a substantial loan. In order to service this debt, AIG committed itself to orderly wind-down of its financial products unit and to sell parts of its insurance businesses. A new "AIG" will concentrate on its core business which is insurance. This will also help to reduce the complexity of its group structure.

**The Basel II approach**

Aspects of the direct approach are relatively more common in the banking sector. The Basel II Framework is applied on a fully consolidated basis to internationally active banks and includes any holding company that is the parent entity within a banking group (although there is no direct licensing requirement for holding companies). All banking and other relevant non-insurance financial activities conducted within a group containing an internationally active bank are captured through consolidation. As regards insurance activities, a bank that owns an insurance subsidiary bears the full entrepreneurial risks of the subsidiary and is therefore expected to recognise on a group-wide basis the risks included in the whole group. For the purpose of measuring regulatory capital of banks, the bank's equity and other regulatory capital investments in insurance subsidiaries are deducted from its balance sheet.

The Core Principles for Effective Banking Supervision further states the following:

- An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
- The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base.
- The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
- The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
- Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis.