NEWSSTAND

The New Regulatory Order

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While the most significant consequence of the global economic crisis is the unprecedented volume of stimulus funds being pumped into the economy, calls for a global regulatory overhaul of the banking industry come a close second.

Inevitably, the insurance industry will not escape these regulatory changes, some of which are long-running projects predating the credit-crunch. In this article, we examine the various reports, initiatives and legislation from major insurance jurisdictions – the European Union (EU), UK, US, Bermuda and China's two special administrative regions of Hong Kong and Macau – that could shape the industry's regulation for the next generation. Before doing so, we will outline the global developments.

Global Developments – the G20

The G20 summit in April of this year provided a vital opportunity for world leaders to discuss the economic crisis. The most notable success was the agreement of a significant global stimulus package of over US$1 trillion. However, it was also seen as important that the G20 agreed on more than just cash injections and broad consensus was reached on a variety of issues. Key pledges included the reparation of the financial system and the rejection of protectionism. As expected, it was also agreed that financial regulation should be strengthened.

Prior to and following the summit, a number of bodies published open letters to the G20, including the Geneva Association, an organisation comprised of CEOs from the world's leading insurance and reinsurance companies. In relation to insurance supervision and regulation, the Geneva Association letter called for the future supervisory architecture to be built on a sound foundation of national regulation that took into account the differences between insurers and other financial service providers. The letter argued that uncoordinated national responses and protectionism were counterproductive to the proper functioning of the financial markets and harmed the international exchange of goods and services. Regulatory reform, it said, must be focused, measured and considered to avoid such pitfalls as excessive capital requirements, which were as dangerous as insufficient capital requirements.

Whether the various bodies tasked with implementing the G20 regulatory action plan take account of the various representations made to them will become clearer over the next six months. Progress will be measured at the next meeting of the G20 Finance Ministers in November 2009.

Europe

The main developments within the EU have been in relation to the ongoing Solvency II project and a recent report by a high-level group on financial supervision, chaired by Jacques de Larosière.

The de Larosière Report

The report, published in February 2009, acknowledged that some aspects of the European regulatory framework have been pro-cyclical and helped turn what was initially a liquidity problem into a solvency problem. The report made 31 recommendations, split between supervisory and regulatory issues, for the reform of financial services supervision. Some of the key proposals affecting insurers include:

- credit rating agencies should be regulated

- the Solvency II regime, including provisions for group support (as to which, see below), must be adopted urgently
  the powers of supervisory authorities should be strengthened where necessary
- core rules should be harmonised by removing national exceptions to European legislation which distort competition or promote regulatory arbitrage
- remuneration policies in financial services firms should be overseen by supervisory authorities, and
  there should be a greater focus on internal risk management, giving senior risk officers high ranks in institutions. The report calls on authorities to inspect internal risk management systems frequently.

Solvency II

Shortly after the publication of the de Larosière Report, the Solvency II framework directive was finally agreed, after significant delay, in March 2009. The proposals have been formally passed by both the European Parliament and the Council of Ministers.

The delay in agreeing the directive was due to a failure to reach consensus on two key issues: group supervision and equity market risk.

The group supervision proposals were seen as an important element of the proposed directive. These provisions would have enabled the regulator of the head office of an insurance group to oversee the regulation of, and set capital levels for, the entire group. Regulators in other jurisdictions where the group operated would have assisted the lead regulator as the need arose. However, ultimately the resistance to the proposals from Member States whose regulators feared being overshadowed by the likes of the UK, France and Germany (who would take the lead in the regulation of the majority of pan-European insurance groups) was too strong. The proposal to allow group capital levels was therefore omitted from the directive. While it was agreed that this could be reviewed three years after the framework is implemented in 2015, the EU has missed the best opportunity it has had to implement a system of international group supervision.

Another key area of contention was in relation to the 'duration approach' to equity market risk. The duration approach is based on the argument that the risk of holding equities declines on a long-term basis. Therefore the capital charge for holding equities should decrease as the length of the liabilities against which they are held increases. It was eventually agreed that member states could use the duration approach for certain life insurance products.

The approval of the framework directive keeps the timetable for implementation of Solvency II by 2012 on schedule.

UK

The Turner Review

The regulator of the financial services industry in the UK, the Financial Services Authority (FSA), published its much-anticipated review of global banking regulation, spearheaded by its Chairman Lord Turner, in March 2009. The review analysed the events that led to the financial crisis and recommended reform based on a 'macro-prudential' approach rather than focusing solely on specific firms.

Although the review concentrated on banking regulation, key areas of regulatory scrutiny, such as capital adequacy and liquidity, are likely to have implications for insurers too. The main causes of the crisis were identified as macro-economic imbalances, financial innovation 'of little social value' and important deficiencies in key bank capital and liquidity regulations:

"The approach [to reform] has to build on a system-wide perspective: failure to look at the big picture was far more important to the origins of the crisis than any specific failures in supervising individual firms," Lord Turner said. "It must reflect the reality of a global financial system without a global government; we need both far more intense international co-operation and greater use of national powers."

The review's key recommendations are:

- more and higher quality bank capital, particularly to support risky trading activity
- counter-cyclical capital buffers built up in good times to be drawn on in downturns
  tighter regulation of liquidity
- regulation of shadow banking activities and credit rating agencies
- changes to the FSA's supervisory approach, building on the Supervisory Enhancement Programme and centring on business strategies, system-wide risks instead of internal processes, and structures, and
- reform of the European banking market, including a new European regulatory authority, together with increased national powers to constrain risky cross-border activity.

The review also touched on credit default swaps, saying a full debate was needed on how to improve regulation in this area. As a start, however, it suggested that clearing and central counterparty systems should be developed to cover standardised contracts.

US

In the US, the federal government under the McCarran-Ferguson Act has authority to intervene in insurance regulation but, for the most part, it has left such regulation in the hands of each of the individual states. In recent years, the federal government has sought to exert greater control over the insurance industry and the states have fought back aggressively to hold on to their authority.

Optional Federal Charter

While the concept of an Optional Federal Charter (OFC) has generated some interest from larger property/casualty insurers and the life industry particularly, it has never proceeded much past the discussion stage due to strong opposition from the National Association of Insurance Commissioners (NAIC), i.e. state regulators, and various trade associations.

The industry's reaction to an OFC, in very simplistic terms, is split based on size, with large insurers mostly expressing support for an OFC, while small and mid-sized carriers largely in opposition. The latter contend that an OFC would put them at a competitive disadvantage.

The OFC bill (first proposed in May and July 2007) and several other federal insurance bills were never even considered last year as Congress's sole focus in the remaining months of the 2008 legislative session was to address the financial credit crisis and the related government bailout of the banking industry.

Now in the aftermath of these financial rescue plans, the call for federal insurance regulation in the US has started to gain momentum. It received the support of a working group on financial reform appointed by President Obama known as the 'Group of Thirty', which was followed by a statement by Treasury Secretary, Tim Geithner, who said that a federal insurance charter had a lot of merit and should be reviewed carefully.

On the heels of these pronouncements from the Obama advisors comes the latest incarnation of federal regulation of insurance in the form of a broad insurance regulatory reform bill that would create an Office of National Insurance (ONI) to monitor the insurance industry for systemic threats. The new legislation, known as the National Insurance Consumer Protection and Regulatory Modernization Act, was introduced in the US House of Representatives in April 2009 by Representatives Melissa Bean of Illinois and Ed Royce of California. The bill would create a federal charter for insurance regulation that would allow insurers the ability to opt for federal rather than state oversight.

Under this proposed Act, the NAIC's model laws on consumer protection would be incorporated into the newly created ONI. This office would provide more uniform regulation of insurers across the country and oversee their financial and market conduct. The legislation would also:
establish a national system of regulation and supervision for nationally registered insurers, agencies and producers

- create a new 'systemic risk' regulator to monitor insurers and gather financial data from insurers and other affiliates in a holding company structure, and
- create a national guaranty corporation that would assess national insurers if a state guaranty association did not provide policyholders with a level of protection equivalent to the NAIC model standards.

According to an independent study released in March 2009, the creation of a new federal insurance regulator would require a staff of roughly 2400 and an annual budget of US$465 million. The study also assumes that approximately one-quarter of regulated entities would opt for federal oversight rather than state regulation.

The Non-Admitted and Reinsurance Reform Act

Another federal initiative soon to be reintroduced in the US House of Representatives would establish national standards for the state regulation of surplus lines insurance. This bill, entitled The Non-Admitted and Reinsurance Reform Act, was approved twice before (in 2006 and 2007) in the House of Representatives, but never made it to the Senate and thus never became law. Among other things, the measure would make accessing the surplus lines market easier for qualified risk managers and create a uniform system of surplus lines premium tax allocation and remittance. Specifically, this bill would give regulators in an insured's home state authority over most aspects of surplus lines insurance, including the right to collect and allocate premium tax with respect to policies with multi-state perils.

This legislation would also ease certain regulatory burdens on reinsurers by giving regulators in a reinsurer's state of domicile the sole responsibility for regulating the reinsurer's financial solvency.

This bill has enjoyed the broadest industry support of any recent insurance regulatory reform proposal with endorsements from insurers and producers, both large and small, as well as life and property and casualty insurers.

Opponents of federal regulation believe that the passage of a federal surplus lines bill would serve as a precursor to the federal government taking insurance regulation away from the states – or the proverbial 'camel's nose in the tent'. Some insurance commissioners, most notably New York's Superintendent of Insurance, Eric Dinallo, have come out strongly against any type of federal regulation of insurance because they believe it would lead to insurers shifting back and forth from federal to state oversight, seeking the most lenient regulator.

Future Tax Treatment of Offshore Reinsurance Companies

Offshore insurers and reinsurers, particularly those based in Bermuda and Ireland, are also under the microscope of the Obama Administration and Democratic Congress. The law they want changed allows large portions of premiums written by US-based affiliates of offshore insurers to be ceded to the reinsurance unit of their parent companies which are based in low-tax or no-tax jurisdictions, such as Bermuda. The affiliate deducts the premium while the foreign parent does not pay US or local tax on the premium and at the same time earns investment income subject to low or no taxes.

This occurs because related-party reinsurance does not result in a transfer of risk outside the global group. It is an efficient way of significantly reducing tax without transferring risk.

Under proposed new legislation, US ceding insurers would be denied a deduction for 'any premiums reinsured in excess of the industry average of reinsured policies', based on published aggregate data from annual statements of US insurance companies. Backers of this proposal contend that limiting the available deduction to ceding insurers will keep excess reinsurance premiums paid to affiliated reinsurers within the purview of US taxation.

Opponents of the legislation maintain that offshore companies play an important role in filling US insurance market needs and argue that it will be most likely to increase the cost of insurance to consumers and may also lead to capacity shortfalls in certain classes of business, particularly catastrophe reinsurance.

Despite these arguments, the Obama White House is likely to feel pressure to shore up the economy and find ways to fund the programs being promoted. This means that the new administration may target this tax revenue as a way to plug holes in the deficit. For this reason, many Bermuda based companies are now preparing for potential changes in tax structure, for example by moving their holding companies to or establishing underwriting platforms in jurisdictions which have tax treaties with the US, such as Switzerland.

Bermuda

At the beginning of the year, the Bermuda Monetary Authority (BMA) published its Business Plan for 2009, which was designed to chart a course to ensure that Bermuda succeeded as a leading financial market. As part of that plan, the BMA proposed to introduce group-wide supervision for certain higher risk insurers and to continue progress towards international mutual recognition for Bermuda.

In the first quarter of 2009, the BMA has worked towards achieving these goals and has published discussion papers on the following.

Group-wide Supervision

By the fourth quarter of 2011, because of their higher risk profile, the BMA proposes to apply its group-wide supervision regime to Class 3B and Class 4 insurers that form part of a financial group or mixed conglomerate. The adoption of group-wide supervision has emerged in light of the credit crisis to help ensure that groups are effectively regulated and that they conduct their operations in a prudent and financially sound manner. Part of the BMA's intention was to ensure that Bermuda's standards were broadly equivalent to international standards being developed in this regard. However, in light of group supervision being omitted from Solvency II, Bermuda may end up with a different regime. The paper includes a discussion on key issues such as the determination of group solvency, the treatment of intra-group transactions, eligible capital, reporting requirements, group corporate governance and risk management.

Roadmap to Mutual Recognition

In working towards mutual recognition, the BMA is concentrating its efforts on achieving equivalence with Solvency II in Europe. However, the BMA is also monitoring other regimes with which it seeks mutual recognition. The regime which the BMA is seeking to create has three core components:

- capital adequacy whereby capital requirements will take into account all aspects of risk (including group risk) and the quality of the capital supporting the business
- governance and risk management which reflects the integration of risk and capital management, and
- transparency and disclosure from the regulator, the firms themselves and the groups the BMA supervises.

The BMA is determined to ensure that implementation of its programme should be achieved in a manner that demonstrates flexibility, adapts the emerging international regulatory framework to the characteristics of the Bermuda market and adopts a risk based and proportionate approach to the different classes of insurer operating in the Bermuda market.

Proposed Enhancements to Insurance Supervision and Enforcement Powers
The BMA is also reviewing its enforcement powers in insurance. The proposals include:

- developing an express power for the BMA to publicise enforcement action it has taken against an entity which the BMA believes would have the potential for significant deterrence
- whether the BMA should seek a power to ban individuals from acting in roles in the industry for a specified period, and
- whether the BMA should have the power to impose a financial penalty on an individual or company and sue through the civil court system.

China's Special Administrative Regions

Hong Kong
For years, Hong Kong has been regarded as a key financial hub, renowned for its geographical location, credible legal system and effective regulatory framework. However, like many other financial centres, Hong Kong has been hurt by the recent global financial crisis.

The Hong Kong Insurance Authority (HKIA) recently released the provisional 2008 statistics of the Hong Kong insurance industry. According to these statistics, although gross and net premiums for general insurance business increased by 11.3% in 2008, the underwriting profit of motor insurance business drastically reversed from a profit of HK$11 million (US$1.4m, £968,500) in 2007 to a loss of HK$259 million (US$33.4m, £22.8m) in 2008.

As a result, on 24 February 2009, the HKIA issued a circular to all Chief Executives of authorised insurers carrying on general insurance business in Hong Kong, expressing concern over insurers' solvency positions and long-term market stability in light of the substantial underwriting loss suffered by the motor insurance business in 2008. The HKIA required all insurers carrying on motor insurance business to submit a 'breakdown of direct motor business by class of vehicle and type of coverage in terms of gross premiums and exposure' together with a quarterly return on Hong Kong business within one month after the close of each quarter, beginning with the first quarter of 2009.

As the financial markets show no sign of strong recovery, insurers are likely to be under intense pressure to ensure that the stringent solvency requirements to which they are subjected are satisfied. We expect the Hong Kong government authorities, including HKIA, to monitor the insurance industry carefully and assess continually the need for intervention.

Macau
On 31 March 2009, the New York State Insurance Department (NYSID) and the Autoridade Monetaria de Macau (AMM, the Monetary Authority of Macau) concluded a Memorandum of Understanding (MoU), which established a formal basis for cooperation and coordination between NYSID and AMM, including the exchange, handling, protection and return of information in their possession and, where appropriate, investigative assistance with respect to companies and persons engaged in the business of insurance.

Pursuant to the MoU, requests for assistance include, among other things, requests to:

- confirm or verify information
- obtain information about a specified person or entity
- discuss issues of mutual interest between NYSID and AMM
- question or take testimony of persons designated by the requesting regulator, and
- conduct inspections or examinations of regulated/related entities or persons.

The MoU provides for a special procedure where confidential information is requested. NYSID and AMM agree to make reasonable efforts to assist each other, subject to the laws and overall policy of the respective jurisdictions.

The MoU also facilitates cooperation in assisting each regulator in carrying out on-site inspections of regulated or related entities and persons in both jurisdictions.

The MoU does not create any legally binding obligations, confer any rights, modify or supersede any domestic laws or regulatory requirements in force in, or applying to, the State of New York or Macau.

Conclusions

It is apparent that a significant amount of work is being undertaken worldwide to ensure that the regulation of insurance is fit for the post-crunch global economy. What the restructured regulatory landscape will ultimately look like is not easy to predict at this stage. What is clear is that there will, in the future, be much greater uniformity of approach between different jurisdictions and co-ordination between national and international regulators.

This can be achieved through a variety of methods. Regulation that is applied internationally is the most effective approach, however the significant length of time it will take for Solvency II to come into force shows that this is impractical during or following a crisis situation, where change is required quickly.

The ability of regulators to declare other regimes as equivalent is a useful tool for ensuring standards can be applied internationally. If implemented properly, ad-hoc arrangements, such as Memoranda of Understanding, between regulators are also a useful tool.

Whichever approaches are taken, the regulation of insurance is likely to change considerably in the near to medium term.