CHALLENGES FACING INSURERS

JONATHAN DIXON

Secretary General - International Association of Insurance Supervisors (IAIS)

Finishing the puzzle: completing the global insurance regulatory framework

The end of 2024 will mark the culmination of a period of significant policymaking for the global insurance supervisory community. Last year, the Financial Stability Board (FSB) endorsed the IAIS' Holistic Framework for the assessment and mitigation of systemic risk in the insurance sector and this year we will finalise the global Insurance Capital Standard (ICS). Taken together, these policy initiatives will ensure more robust international standards to better protect policyholders and to help maintain global financial stability.

The Holistic Framework includes three elements: globally-consistent macroprudential supervisory measures; an annual Global Monitoring Exercise (GME) and robust assessment of its implementation by IAIS members.

The GME provides an important empirical basis, allowing for a data-driven assessment of the key risks and trends in the global insurance sector – covering more than 90% of the global written premiums. Sector-wide highlights from this work are published in the IAIS Global Insurance Market Report (GIMAR), and individual insurer results and measures are reported to the FSB. The 2023 GIMAR shows that solvency, liquidity and profitability positions decreased slightly in 2022, albeit remaining well above regulatory thresholds on aggregate. Key drivers of these declines were lower asset valuations – including declines in equities – widened credit spreads on corporate and sovereign debt, higher volatility of interest rates and weaker currencies in some jurisdictions. Looking ahead, most supervisors expect a stable or slightly negative outlook for the insurers in their jurisdictions, particularly in light of uncertainties in the economic and geopolitical environment.

Our 2023 risk assessment had a particular focus on liquidity and credit risk in the face of challenging macroeconomic conditions. The GME also provides a basis to consider ongoing trends in the sector. For example, we are examining structural shifts in the life insurance sector, including the trend towards greater investment allocation to more complex, less liquid assets and increased use of asset-intensive cross-border reinsurance. The outcomes of our analysis are highlighted in the 2023 GIMAR and will be the topic of discussion for a Eurofi panel in Ghent.

Implementation of the Holistic Framework is progressing well. Last year the IAIS published a report on our assessment of implementation of the Holistic Framework standards in 10 major insurance markets. The assessment showed good levels of observance across many of the standards, with further work identified to address remaining gaps. This year we continue our assessment in six more major markets.

This year will see the finalisation of the global ICS. Our adoption of the ICS in December 2024 will be the culmination of a journey of more than a decade, marked by extensive analysis and consultation. The ICS will create, for the first time, a common language for the supervisory discussion of the solvency positions of Internationally Active Insurance Groups (IAIGs). In addition, it will help enhance global convergence among group capital standards, incentivise prudent management of IAIGs and enhance transparency.

Last June, we consulted on the candidate ICS as a Prescribed Capital Requirement (PCR) Last year we collected over 30,000 individual data points per insurance group, even before counting information on financial instruments. In total, we have collected over 4 million data points over the last three years, meaning that the ICS is one of the most empirically tested and widely consulted global regulatory standards.

> **These reforms will strengthen supervision of IAIGs and the stability of the global insurance sector.**

In parallel, US supervisors are developing an Aggregation Method as their implementation of the ICS. Last March, the IAIS published the final criteria by which it will assess whether the Aggregation Method will provide comparable outcomes to the ICS. The comparability assessment is now underway. It will be a robust, technical and evidence-based analysis of comparability. If deemed comparable, the AM will be considered an outcome equivalent approach for implementation of the ICS as a PCR.

Finalisation of these reforms will strengthen supervision of IAIGs and the stability of the global insurance sector. As we complete the policy design phase this year, increasingly our focus will shift to implementation support and assessment, alongside our continued priority on forward looking risk assessment.

GARY ANDERSON
Commissioner - Massachusetts Division of Insurance

Weathering an evolving insurance climate

Climate perils. New ownership models. Cybercrime. Interest rate swings. Alternative investments. The insurance industry is no stranger to emerging issues and challenges; however, given the increased frequency and expense, the industry is at an inflection point where insurers and supervisors must adapt to ensure competitive, fair and safe markets. Fortunately, the strength of the U.S. system is its flexibility to address evolving risks.

U.S. state insurance supervisors reached an inflection point in the early 1990s following a tumultuous 1980s that saw a large number of insurer insolvencies. These failures highlighted problems with the then current regulatory framework and the need to be more risk-focused.

As a result, a new Risk-Based Capital (RBC) approach was developed that would better account for these factors. RBC formulas for life, non-life and health were implemented in 1993, 1994, and 1998, respectively. This system has proven incredibly resilient and robust since its inception, having weathered major crises in 2008, 2020, and 2023, especially in comparison to other financial sectors.

U.S. state insurance supervisors understand that no system can remain static. Challenges, such as innovation in both insurance products and insurer investments, and evolution of other risks, like climate, have led to reviews of RBC to ensure that the new risks are being captured appropriately. Looking forward, work is underway to address evolving risks including climate risk and resiliency and insurer investment practices.

Climate risk and resiliency remain a top priority to U.S. state insurance supervisors. After careful consideration, the NAIC climate survey was updated to align with the TCFD to better harmonize data globally, and the RBC calculation has been reviewed to include the addition of wildfires. Convective storms are expected to be considered soon as well. The NAIC will be conducting a data collection on the availability and affordability of insurance, empowering our members to better understand each jurisdiction and regional trends. Cutting edge solvency tools are being implemented to help analyze future scenarios to better understand solvency issues for the insurance sector. Information on these and other recent collective action taken by the state insurance supervisors can be found in the forthcoming NAIC National Climate Resilience Strategy document.

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Regarding the emergence of complex organizational structures and complex investments, the NAIC has been active in monitoring these developments, including creating a list of 13 primary regulatory considerations. As part of addressing these considerations, U.S. state insurance supervisors are reviewing existing guidance and considering updates and/or new requirements to enhance their ability to assess riskier activities associated with these business models.

Maintaining a risk-based supervisory approach that can be flexible enough to address evolving risk and opportunities requires supervisors to gain a strong understanding of each insurer, including the products they write, the corporate structure they operate within, and the market forces that may be impacting them. This requires a greater level of knowledge, training, and expertise amongst staff. However, this too is an ongoing challenge with factors such as the rapid pace of change and turnover and retirement amongst experienced staff.

Finding ways to navigate these evolving risks in a changing insurance sector does not occur in a vacuum. International collaboration among insurance supervisors on a global scale can help ensure risks are being addressed effectively and in a timely manner. The International Association of Insurance Supervisors and its members have a variety of workstreams focused on these evolving risks and are taking steps to finalize important policy developments, including the International Capital Standard that aims to provide a common understanding of the capital adequacy of internationally active insurance groups. Part of this project includes an assessment of whether the Aggregation Method provides comparable results to the ICS. While we look forward to a successful conclusion on comparability and that the final ICS is ultimately fit for purpose, projects such as this reinforce the importance of supervisory collaboration and understanding.

The insurance sector landscape has changed since the introduction of the RBC system 30 years ago, but the system has demonstrated itself to be incredibly robust, recognizing the importance of flexibility to address evolving risks. By looking out for new risk and responding accordingly, the insurance sector can address the challenges we face in a forward-looking and comprehensive way.

ALBERTO CORINTI
Member of the Board of Directors - Italian Insurance Supervisory Authority (IVASS)

The impact of the sudden increase of interest rates on insurance

The "low for long" interest rate context of some years ago represented one of the main global challenges for life insurance. The subsequent sudden and dramatic increase of interest rates has presented different but equally serious challenges which we must not disregard, but rather learn from.

In Italy, on average, the increase in interest rates has impacted insurance companies through a combination of increased surrenders on the liability side and of valuation losses on the asset side. The consequent materialization of liquidity risk was not related to the inability to convert assets into sufficient cash flows to face increased liquidity needs, but instead to the difficulties in getting those cash flows without selling depreciated assets and realizing economic losses.

The intensity of the impact on individual companies depended on a number of factors; the main ones being:

- The degree of liquidity of the liabilities: i.e. the easiness for policyholders to surrender the policies in response to market factor movements. Insurance policies are normally associated with lower liquidity than pure financial products. However, their design and other market factors (e.g. level of surrender penalties, significance of the protection component compared to the pure investment component, habits of consumers) could make the level of surrenders more sensitive to the return that can be earned by investing in pure financial products;
- The type of distribution channel: banking or financial distribution networks tend to emphasize the financial component of insurance policies, using selling practices that present insurance policies as an alternative to pure financial products. This is particularly relevant in case of non-proprietary networks, where the interests of the insurance company might not always be aligned with those of the distributing entity. Market evidence in Italy showed this very clearly;
- The company's asset allocation and the correlated amount of valuation losses: this obviously depends on the amount and duration of fixed interest bonds in the portfolio.

Liquidity becomes a concern whenever the design of the products departs from traditional insurance.

In principle, the combination of the above features has the potential to impact the solvency position of companies and - on a large scale - trigger systemic effects.

What can we, as supervisors, learn from that?

First of all, experience confirmed that, even if liquidity is not in principle a primary risk for insurers, there are situations that require appropriate monitoring tools, effective preventative measures and capacity to intervene if necessary. The closer a company's business model resembles that of a bank or an investment firm, the more the typical insurance supervisory tools and practices need to be enhanced. The review of Solvency II will introduce new tools to monitor and manage liquidity risk and the IAIS, in the context of the Holistic Framework, has enhanced its prudential standards in this regard, also as a mitigation of systemic risk. It remains to be seen whether this will be sufficient. In any case, supervisors should pay attention to the companies' combined liquidity risk exposure, also considering structural and qualitative aspects such as the design of their products, their distribution model and the features of any related commercial agreement.

Also, experience has shown that the exposure to liquidity becomes a concern whenever the design of the products departs from traditional insurance. This is also connected to the wider issue of the social role of life insurance and the importance of maintaining the protection purpose at the core of the insurance business model. A life insurance market where the protection component is negligible might not only fail to fulfil the need of consumers, but also become less sustainable in the long run.

Finally, the experience underlined the importance for insurers to take all risk exposures into account in their risk governance system, including risks which are not considered in the standard calculation of capital requirements. Indeed, asset allocation or other management actions could sometimes be shaped to a dangerous extent with the only purpose to minimize capital requirements on certain risks - thereby disregarding the consequences on other risks, including those that do not imply capital requirements, such as liquidity risk.

We have to recognize, however, that the current economic context is quite extraordinary and that, despite its challenges, the insurance sector has demonstrated resilience, also thanks to its good solvency position and risk governance.

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Global challenges – Global solutions

With a business model relying heavily on the aggregation and diversification of risks, the insurance sector has naturally developed a strong international dimension. This materialises through a large number of Internationally Active Insurance Groups (IAIGs) operating cross-border, and the importance of international reinsurance markets.

The financial services industry, especially the insurance sector, has grown more interconnected across sectors and geographically. The range of activities of insurers expanded from traditional biometric and casualty coverages to investment and saving products with large impacts to their risk profile. In this environment, international cooperation is crucial to address current challenges.

One area in which this is visible concerns global financial stability. The former entity-based G-SII model, while adequately capturing signals from individual entities, missed the ability to intercept trends or common behaviour in the insurance industry. Working together at the International Association of Insurance Supervisors (IAIS), the global supervisory community developed the Holistic Framework (HF), which aims at addressing such limitations. Building on the three pillars of the Global Monitoring Exercise (GME), enhanced policy material (ICPs and ComFrame), and Implementation Assessment, the HF establishes a globally consistent supervisory approach to contribute to financial stability.

The shift from the G-SII designation to the HF represents a leap forward, also in terms of complexity. Widening the scope of the assessment and extending the application of standards to a larger number of groups upon supervisors' assessments requires a high level of cooperation, transparency, and consistency in the approaches to grant a robust and homogeneous risk assessment globally. Moving forward, the supervisory community will need to ensure that the HF evolves to capture key trends and risks that might emerge at individual and sector level.

Another global challenge facing the insurance sector concerns the availability and affordability of nat cat insurance coverage, as shown by recent statistics on protection gaps across the globe.[1]

The IAIS' call to action highlights the role of insurance supervisors in addressing nat cat protection gaps.[2]

Supervisors are part of an ecosystem to support the availability of insurance and to advise government and industry on financial inclusion and societal resilience. This involves advising on the design and implementation of public-private partnerships or insurance schemes.

Challenges to the insurance sector don't stop at national borders - Global cooperation is key.

Sound and effective supervisory cooperation can be largely enhanced if the relevant authorities share, to the extent possible, a common language and supervisory approach. This is what the IAIS is pursuing with the development of the Insurance Capital Standard (ICS).

The aim of the ICS is to define a common language for the supervision of internationally active groups. In this regard, the journey and the destination are important. The monitoring period has already been a success, improving mutual understanding and enabling the development of a robust, risk-based standard that was subject to a public consultation last year.

EIOPA has always been fully engaged as a member of the IAIS to promote effective and consistent global supervision of the insurance sector. We believe the ICS should reflect the key building blocks of Solvency II, which have proven to be effective. We look forward to the finalization of the ICS and its expected adoption as a Prescribed Capital Requirement (PCR) this year, as we believe it will strengthen the resilience of the sector worldwide at a time of global transformation.

Being a minimum standard, jurisdictional implementations of the ICS will be key to determine its effectiveness. In the EU, Solvency II should be the practical implementation of the ICS, as it delivers on all the key elements of the ICS with a sufficient degree of prudence. EIOPA is open to the ongoing IAIS comparability assessment of the Aggregation Method (AM), as the possible solution for implementation of the ICS in the United States. Building on the agreed set of robust IAIS criteria, it is crucial that the assessment remains credible and evidence-based.

The insurance sector faces numerous challenges, many of which cannot be effectively addressed by national supervisors operating individually. EIOPA will keep cooperating closely with its international counterparts for the benefit of policyholders and financial stability, both in the EU and globally.

1. *Record thunderstorm losses and deadly earthquakes: the natural disasters of 2023 | Munich Re.*
2. *IAIS-Report-A-call-to-action-the-role-of-insurance-supervisors-in-addressing-natural-catastrophe-protection-gaps.pdf (iaisweb.org).*

HIDEHIKO SOGANO

Member of the Board of Directors, Managing Executive Officer - Dai-ichi Life Holdings, Inc.

Challenges facing the Japanese insurance sector in the fast-evolving world

The environment surrounding Japan's life insurance market is not necessarily positive, with structural factors such as a declining and aging population, long-term sluggish growth in real income, and low insurance participation rates, especially among young people. If we look at the value of new contracts, it has been on a gradual downward trend for the past 15 years. In addition, in recent years, various negative factors have been added, such as a decline in sales due to the COVID-19 pandemic, an increase in natural disasters, and the appearance of conduct risk on the sales side, making management difficult.

However, major companies have taken prudent asset and liability operations and there are no acute solvency issues. In other words, we have a huge stock of long-term insurance contracts from the past, and stable long-term investment, mainly with the government bonds supplemented by the conservative alternative investment.

There is a possibility that Japan will finally be able to break away from the zero-interest rate policy, but for the time being, it will likely be limited in scope. In addition, most insurance contracts in Japan come with a protection feature and given the difficulty of re-enrolling such as the surrender penalty, we believe that a rise in interest rates is unlikely to cause an extreme increase in cancellations, though we should not neglect the liquidity risk in the insurance sector.

Currently, listed insurance companies are pursuing capital efficiency and governance reforms. The risk-free rate is expected to gradually rise in Japan in the coming years, but investment capacity is increasing by improving capital efficiency through measures such as reducing market risk by divesting equities and utilizing reinsurance. Investment targets include, firstly, IT investment based on a new digital strategy, as the use of AI has the potential to dramatically transform business efficiency, and secondly, not only pure insurance business, but also investment in a platform to expand our business into areas surrounding insurance to become a lifelong partner for the customers, and thirdly, overseas markets that are expected to grow in the future. As we will develop these in an inorganic manner, we may see meaningful changes in the business models of the insurance companies and their governance reforms.

Insurance industry is in a phase of business model transformation over the years.

Regarding climate change, transition risks and physical risks in the Japanese insurance industry are becoming more likely to materialize and need to be firmly recognized as management issues. In terms of physical risks, the extreme heat in the summer is becoming more severe, which is jeopardizing the public's health and leading to an increase in insurance claims. We have experienced an increasing number of large typhoons which damaged offices and houses. Regarding transition risk, given Japan's industrial structure, its potential risk is greater among the G7 countries. This is a matter of great concern, and all Japanese insurance companies, as institutional investors, are very actively addressing this issue.

I believe that outlining transition plans in line with the framework of the GFANZ is significant in clarifying the current challenges. While reducing insurers' emissions is crucial and a good way to raise employee awareness, a more fundamental theme is how to achieve a reduction in the emissions of investees and how insurance companies can contribute to this. In Japan, we try to encourage regional financial institutions to promote such initiatives and to foster understanding among SMEs in the regions. Therefore, the development of easy-to-use data collection tools is urgently needed, and we do hope that the NZDPU (Net-Zero Data Public Utility), launched at COP28, will be available soon.

In addition to the risk of being held accountable for the mismanagement of climate risks by insurance companies, there is also the litigation risk arising from the impact of climate change on investment decision-making. While there haven't been prominent lawsuits in Japan yet, information disclosure and communication are certainly becoming more critical than ever to ensure stakeholders have a correct understanding.

Lastly, we also find a variety of entities are developing climate-related risk assessment tools for the insurance sector. One ESG vendor quantifies the impact of climate change on investees and insurance companies can refer to the results when selecting companies to invest in and finance. When using such tools, we should be prudent that these assessment tools still have issues in terms of accuracy, effectiveness, and transparency. Therefore, it is important for insurers not to use them at face value, but to accurately understand the logic of each evaluation method and utilize it appropriately in management decisions.

MIREILLE AUBRY
Direction Prudential Regulation Standards & Foresight - COVEA

The fundamentals of insurance have not changed and the sector remains resilient

The unprecedented changes encountered in the financial, economic, and social environment have created a very challenging environment for market participants for decades. Our economies are still penetrated by the leftovers of the 2008 crisis. The banking sector has been at the core of this crisis due to unsustainable lending and investments behaviors. Conversely, the traditional insurance sector has not been an underlying determinant of the crisis and has not suffered from interconnectedness with banks but rather from the consequences of the management of the crisis with non-conventional monetary policies that have created ever lower interest rates.

The low interest rates have had strong negative impacts such as the creation of bubbles in the value of real estate and other assets such as equities in complete disconnection with actual domestic production and paving the way for future inflation that has eventually soared. Negative interest rates have been observed in real terms and even in nominal ones, both situations strongly disincentivizing the investment of savings in the productive economy, the very one unique true fuel which should be recognized, cherished and encouraged for long-term investments.

The industry sector in France has suffered from insufficient financial returns on investments that have impacted both life business (unfair remuneration) and non-life business (the absence of remuneration of reserves not contributing to dampen the price of insurance covers).

Because of the soaring of inflation, interest rates have abruptly been driven upwards in 2022. This has caught many actors by surprise, including regulators for instance in the context of the solvency 2 review, which started at a time of historically low interest rates. The focus remains on the need to remove barriers to the long-term financing of a productive and sustainable economy. Higher interest rates are in fact a general positive news since financial remuneration is desperately needed. The abrupt change in interest rates in a short space of time has been absorbed by the adequate ALM stance that has been deployed during the low & negative interest rates period whereby the duration of fixed-income assets was reduced with very significant cash holdings, thus much limiting sensitivity to the upward shock and enabling accreditive investments swiftly on high rates and longer durations. The Eurovita's resolution in Italy remains a marginal case that may be more attributable to factors intrinsic to the company.

The industry sector in France faces many other challenges such as the rising of claims costs for property and casualty both through severe inflation and the cost of new technologies and equipment, the increase of the cost of natural disasters. Yet all this appears manageable with the typical risk management tools and actions insurers have available.

The insurance sector shows a strong resilience, it remains the best rated sector with the fewest defaults.

The fundamentals of the insurance business model have not changed. Asset allocation remains based on the triptych of quality/security, profitability and liquidity. It remains essential to have an "entity-specific" asset allocation, i.e. one that is adapted to the nature and risk profile of all liabilities (in particular policyholder liabilities and equity horizon). Investments based on these target allocations must also incorporate adequate diversification. For all this to function though, we desperately need to remain accurate in our analyses and fundamentally risk-based. Any bias whether inadvertently or intentionally forced in may ruin the equilibrium of insurance. For instance, non-life insurance may prove very resilient until insurers are not hindered in their ability to reprice according to the real cost of covers by inappropriate rules.

With regards to the cost of natural disasters, it is closely monitored through frequency, scale, and cost. Studies are ongoing and measures have already been taken to ensure the solvency and sustainability of the French CatNat public-private partnership under which an elaborate functioning is operating so that all stakeholders have a complementary and effective role to play. The system is providing a compensation response commensurate with the scale of damages: average events are borne jointly by insurance and public reinsurance, more serious events or claims are covered to a greater extent by public reinsurance, and major events involve all players: insurance, reinsurance and the State.

Any bias whether inadvertently or intentionally forced in may ruin the equilibrium of insurance.

With regards climate change, the weighs of physical risks appear clearly manageable all the more so that a common major risk under French non-life insurance, such as winter windstorm is not affected. With regards transition risks, they are happening everyday and much of the climate and sustainability issues are already informing financial markets in a way that embeds it with numerous other factors and cannot be isolated.