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Challenges for Global Regulatory Reform in Insurance

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It is my great pleasure and honor to be here with you today to share with you some of my thoughts regarding the direction of regulatory reform in the insurance area and what our plan of action should be.

1. Insurance Regulation in a Rapidly Changing Environment

First, let us face reality. We live in an increasingly globalized marketplace for insurance. Despite the recent deep financial crisis that culminated in the failures or publicly-funded bail-outs of major insurance firms with a global presence, insurers have again been expanding their activities worldwide. When managed properly, and regulated and supervised appropriately, those cross-border activities of internationally active insurers provide reliable and efficient services to consumers and businesses. Cross-border insurance coverage is a necessity for trade flows, and cross-border activities of insurers could bring huge benefits in extending insurance coverage that domestic insurers have difficulties in providing. Insurers that operate cross-border need to be sound and resilient against financial market stress. The challenge for insurance regulators worldwide is how to apply regulation in an appropriate manner to the cross-border activities of insurers without unduly restricting their ability to provide those services in an efficient manner. Financial stability has become of the key objectives for insurance regulators as well. There is a crucial need for regulators in different jurisdictions to cooperate and coordinate their actions cross-border. The coming decade will, in my view, be a historical turning point for insurance regulation and supervision worldwide.

2. Evolution of the Regulatory Framework

To be sure, insurance regulators have been working hard to cope with this reality of the globalized marketplace for many years. Group supervision

has become a necessity, as insurance groups expand their businesses across sectors and transcends state and national borders. The International Association of Insurance Supervisors (IAIS) has been making great progress in developing standards for insurance regulation and supervision for many years. The global financial crisis has added urgency to efforts to strengthen international cooperation and coordinated action by insurance regulators worldwide. The IAIS has spearheaded those efforts by developing international standards and guidance to effectively cope with the realities of the globalized insurance marketplace. Most recently, work to develop international capital standards for Insurers worldwide has started at IAIS, in consultation with the Financial Stability Board (FSB) that leads and supports this work as the coordinator of standard-setters and regulators across different financial sectors. The work to address systemically important insurers is progressing at the IAIS and FSB. Work to enhance the intensity and effectiveness of the supervision of insurers is also gathering pace. An effective framework to enable the orderly resolution of systemically important insurers has become a matter of priority for insurance regulators, as well as regulators of banks and non-bank non-insurance financial institutions. While I do not have time to address all of those reform efforts, I would like to mention a few words on each of three issues: (i) group supervision, (ii) international capital standards and (iii) systemically important insurers.

3. Group Supervision

After talking about the increasingly globalized nature of contemporary insurance markets, it may appear somewhat awkward to talk about the increasing need for group supervision. The fact that we are still debating the case and the process for applying group supervision to internationally active insurers is a stark demonstration of how regulation and supervision have lagged behind the realities of the globalized marketplace. The still fragmented nature of insurance regulation and supervision, both internationally and also sometimes even within a jurisdiction is a reality deeply rooted in the evolution of the regulatory framework over insurance and is something that we now need to overcome. Incidents during the financial crisis unequivocally showed that fragmented and partial

regulation of internationally active insurers is simply not up to its task of ensuring the soundness of those insurance groups, and of preventing systemic crisis. At the JFSA, we have established a system of consolidated supervision with full regulatory authority over insurance groups starting from the group holding company level. While we can accept that other jurisdictions may not necessarily have the same regulatory powers, we strongly believe that regulators need to have full information and authority over the material activities of an insurance group in order to exercise proper oversight for the protection of insurance policyholders. One of the lessons from the demise of AIG a little more than five years ago was that insurance regulators could not prevent risks emanating from a non-insurance subsidiary of the holding company cause the near-failure of the entire group. If a bail-out of the entire group by public support is to be avoided as much as possible in the future, regulation should require the group to be sound and well-capitalized on a consolidated basis, and enable supervisors to directly apply corrective measures to redress the situation at the holding company level.

4. International Capital Standards for Insurers

As you are aware, the IAIS has embarked on the development of the Basic Capital Requirements (BCR) and the International Capital Standard (ICS). The BCR is initially for the purpose of developing a common standard as the basis for requiring Higher Loss Absorbency (HLA) for Global Systemically Important Insurers (G-SIIs). The ICS has the aim of applying a set of common international capital standards to Internationally Active Insurance Groups (IAIGs). While I do not intend to go into the details of the work underway, it may be useful to ask what this work is meant to achieve. This work is particularly significant as it should provide the basis for developing a common set of international capital standards for internationally active insurers for the first time. In an increasingly global insurance marketplace, a common yardstick for comparing and ensuring the soundness of internationally insurance groups is an imperative. However, I would like to offer some conditions for this work to be useful, and for making the newly developed standards effective and operational. First, those standards need to cater for the specificities of the risks

relevant for insurers. They must not unintentionally discourage insurers from writing long-term contracts or making long-term investments. In other words, an overly simple non-risk measure would not serve its purpose well. Any variety of the "leverage ratio" as conceived in the banking context would not seem appropriate, to the extent that insurance is a business that must cover "risk". A leverage ratio that simply measures the proportion of the capital account relative to the size of the balance sheet is not an appropriate measure of the capacity of insurers to appropriately cover risk. The BCR should therefore be risk-based, and sufficiently robust in measuring the resilience of insurers against insurance risk covered by the insurers.

There is an outstanding question of how the ICS should relate to, or eventually replace the BCR. I am not sure whether this question can be debated usefully without first having a clearer idea of the design features of the BCR. My personal view is that the BCR should form the basis of an ICS, and the ICS should eventually replace the BCR. A risk-based approach for BCR would enable this approach. The second condition is the timing. The BCR is required to be developed quite rapidly, i.e. by the end of the year, according to the present FSB timeline, but speed should not be the enemy of the good. I would certainly appeal for caution against a too-hasty approach for developing the BCR. And the third condition is that any standard should eventually be applicable to internationally active insurers globally. If applied only in a handful of jurisdictions, it would not be helpful. In fact, it could be harmful if it laid the ground for regulatory arbitrage and distorted markets.

5. The Issue of Too-Big-to-Fail in Insurance

The designation of Global Systemically Important Insurers (G-SIIs) has now taken place at the FSB and IAIS, based on an agreed assessment methodology. While there is still some controversy over the designation process, and the applicability of the methodology to reinsurers, I would like to emphasize that this methodology has undergone intensive and repeated scrutiny at the IAIS and FSB in its development, and tested through repeated data collection from a large pool of internationally active insurers. It has proven to be sufficiently robust, and, importantly, produces results that are broadly in line with the intuition of supervisors. I would argue against making quick and premature decisions in trying to wholly or partially override the results obtained through the use of this methodology. Some remaining questions are, for example, how to properly treat insurance subsidiaries of bank holding companies assessed under the methodology for Global Systemically Important Banks (G-SIBs), and the treatment of non-bank, non-insurance entities in an insurance group. Working together with the Basel Committee for Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO), under overall coordination by the FSB, is necessary in addressing those issues.

6. Challenges for Regulatory Reform

Finally, I would like to mention one word on the cross-sectoral nature of regulatory reform. In this globalized marketplace, the traditional divisions by sector have been blurring, and sometimes have become meaningless. A bank, a broker-dealer, and an insurance company may be conducting the same activities. To the extent that such activities are relevant for financial stability, and subject to the global reform efforts, one would need to face up to the challenges of preventing unintended consequences of those reforms that transcend sectoral divisions. I have no time today to go into those issues in depth, but would just list three major challenges in global financial regulatory reform, particularly in going forward into the implementation phase of the reforms.

One is to prevent any conflicts, inconsistencies and overlaps between rules of different jurisdictions, and between rules that apply to different sectors. Reform of the OTC derivatives market has amply demonstrated the difficulties of coordination between reforms of different jurisdictions in a multilateral context. While I should note that a lot of progress has been made in this area in recent months, the process has been a long and difficult one.

The second challenge is to prevent inconsistencies between the various measures in terms of the incentives and disincentives that a combination of measures would create. Again, the Basel III capital and liquidity rules could create incentives that offset those installed by measures for

promoting centralized clearing and reviving sound securitization markets. If the bank liquidity rules are to produce the intended consequences, banks will be required to hold more liquid assets, but collateral requirements and minimum haircut rules may create shortages of those liquid assets, unless the requirements are calibrated appropriately.

And the third challenge is the need to take stock of the cumulative effects of the various reform measures, and is to be able to adjust the applied measures if such effects turn out to be overly burdensome or ineffective taken together. In some cases, dealing with those challenges requires political leadership and support. Therefore, all this is easier said than done, but we need to have the courage to be able to adjust when the measures appear to be causing unintended consequences of the kind I mentioned.

7. Concluding Remarks

Those are certainly most exciting and eventful times in the history of financial regulation and supervision. When considering the design and implementing financial regulation, it may be useful to confirm the basic objectives of regulation; i.e. to protect the consumers of financial services, to maintain the integrity and stability of the financial system, and ultimately to ensure that the role of financial markets and service providers in supporting sustainable economic growth and development are performed well. Insurance regulation is an integral piece of this set of financial regulation, but should also be attuned to the specificities of the insurance sector, particularly the role of insurance in providing the means to undertake risks from long-term investment, and in supporting the post-retirement wellbeing of people.

Regulation is not an end in itself; it is only a means of securing sound and efficient financial systems that provide vital services to the entire economy. While this may sound too obvious, I sometimes feel our discussions over the numerous details of financial regulatory reform risk losing sight of this overarching objective. I would like to conclude by stating that if there is any piece of regulation that would appear out of place in light of this fundamental objective, we should have the courage to revisit it. In a changing world, businesses must change, for sure, but regulation must also change accordingly. - Thank you very much for your kind attention.