CASE STUDY
GROUP-WIDE SUPERVISION

Background Case

Structure of the Insurance Group

A property and casualty insurer ("Ins") operates from Jurisdiction A. It has branches in several overseas locations. Ins is a member of a group comprising a parent holding company ("Hold"), a non-regulated financing company ("Fin") and a reinsurance company ("Rein"). Ins is wholly owned by Hold. Ins has a 60% ownership share in Fin. Hold owns the other 40%. Rein is a wholly owned subsidiary of Fin.

Hold is incorporated in Jurisdiction A; whose insurance framework does not regulate holding companies directly. It does provide sufficient powers for the supervisor to use an approach commonly known as the "follow-up approach" or "indirect approach", whereby information on the non-regulated entities is obtained through the regulated entity, e.g. through Ins. Fin is incorporated in Jurisdiction B, and Rein is incorporated in Jurisdiction C. The group's risk management and internal controls are centrally controlled, with Hold's board approving the policies and procedures, and significant transactions of the group. Hold's board relies heavily on the senior management of Ins to run the insurance business. Hold also provides many central services to the group through a separate non-regulated operating entity ("NROE"), including accounting services.

Initially, Fin's primary business was to enter into interest rate swaps with major corporations, including banks, insurers and other large non-financial companies. Over the last 5 years, Fin began to expand into other credit derivative lines, including credit-linked notes and credit default swaps ("CDS"). Some of Fin's counterparties have bought credit protection from Fin in order to reduce their regulatory capital requirements. Fin's operations have so far appeared highly profitable. As a result, Hold's board members agreed to the group's expansion plans three years ago whereby Fin was provided with a large loan from Ins which it then used to form Rein. Rein's primary role is to provide reinsurance coverage to Ins. Rein has also provided significant loans to Fin to assist in expanding its credit derivative business. Rein continues to write profitable business as rates have been on an uptrend.

Supervisory assessment

Ins has had several on-site assessments by its insurance supervisor ("Supervisor A") over the last several years since Ins is the third largest insurer in Jurisdiction A by total assets. Supervisor A has deemed Ins to have adequate capital resources given it is reinsured by Rein. Supervisor A receives management accounts from Ins in relation to Rein, and has determined from these that Rein is heavily capitalised and would be able to honour its reinsurance obligations. Last year, Supervisor A heard a rumour that Fin was being investigated in relation to its asset valuations. Supervisor A heard that the insurance supervisor in Jurisdiction B ("Supervisor B") was concerned because several large insurers in Jurisdiction B were relying upon Fin for credit protection. The story particularly caught Supervisor A's attention since Fin comprised a major asset on Ins's balance sheet, and the large intercompany loan. Both would materially impact Ins's capital adequacy position.

Supervisor A used the indirect approach to request Ins to obtain information regarding the story and received written correspondence from Hold's board providing assurance that there was no basis for the rumour. The correspondence appeared to provide sufficient detail. Accordingly, Supervisor A felt no need to pursue the matter further.

Group Financial Distress

Due to its AAA credit rating, Fin had not been required to post collateral for counterparties for the credit protection; however, it turned out that Fin had misrepresented its financial position. Fin had failed to record significant mark-to-market losses. As a result, Fin's credit rating was downgraded. The rating action immediately triggered margin calls on its credit derivatives. To avoid failure, Fin in turn borrowed some funds from Rein. Shortly thereafter a catastrophic windstorm hit Jurisdiction A for which Ins required the reinsurance protection provided by Rein. Rein was unable to settle its obligations on account of insufficient liquidity. There were news reports which showed policyholders of Ins in several jurisdictions queuing up to cancel their policies. Supervisor A also discovered that it has been misled by Hold's board.

Instructions

You have been invited to attend the first supervisory college meeting for Ins Group. The agenda for the meeting is shown below. In your groups, review the agenda and prepare the points that you will make at the meeting.

AGENDA
MEETING OF SUPERVISORY COLLEGE FOR INS GROUP

Time allocation: 40 minutes

Agenda 1 – designating the group-wide supervisor

The meeting will designate a group-wide supervisor for Ins Group. Justifications will be provided for this selection.

Agenda 2 – risk assessment

One of the functions of the supervisory college is to assess the risk exposures, financial soundness and group governance of the insurance group. The meeting will identify the risks arising from the non-regulated entities within the group.

Agenda 3 – supervisory measures

The meeting will discuss the appropriate supervisory measures that will be put in place that will enhance the supervisory of Ins Group.

A representative from each group will present the points that your authority will raise at the meeting for all the agenda items above in not more than 10 minutes to the wider group.