CASE STUDY ON GROUP-WIDE SUPERVISION

RECOMMENDED SOLUTIONS
(to be provided to participants separately from the Background Case)

Agenda 1- Designation of the group-wide supervisor

The *Guidance paper on the role and responsibilities of a group-wide supervisor* states that in principle, the supervisor in the jurisdiction where the group is based and where that supervisor has the statutory responsibility to supervise the head of the group should be first considered to take the role of the group-wide supervisor. Other factors to consider in determining the group-wide supervisor would include:

- the location of the group's head office, given that this is where the group's board and senior management is most likely to meet, and ready access of the group-wide supervisor to the group’s board and senior management is an important factor

- where the registered head office is not the operational head of the group, the location where:
  i. the main business activities of the group are undertaken
  ii. the main business decisions are taken
  iii. the main risks are underwritten and/or
  iv. the group has its largest balance sheet total.

Given that the group was centrally controlled from Jurisdiction A, and Supervisor A had follow-up/indirect approach powers, Supervisor A appears to be best positioned to be the group-wide supervisor. This is underscored by Ins being the top insurer, having an ownership stake in Rein by reason of the former’s 60% holdings in Fin.

Agenda 2 – Risks from non-regulated entities

<u>Governance and risk management</u>

- Hold’s board was unaware of, or not attentive to the specificities and risks of Ins. The decision to expand Fin’s business was not aligned with the interests of Ins. As a result of this strategic decision taken at the holding company level, Ins was adversely affected. The interaction between the risks taken by Fin and the Ins were not well understood or managed by Hold’s board.
- Given that large parts of the risk management function are located at Hold (which is non-regulated), requirements on risk management at the group level were less stringent than that imposed on Ins. This may explain the different risk cultures between the regulated and non-regulated parts of the group. Hold’s board has a higher risk tolerance over complex financial products such as CDS.
- Fin was used by the group to engage in underwriting CDS that would otherwise not be allowed in Ins and which could endanger the financial safety of Ins. Such regulatory arbitrage opportunities create regulatory gaps between sectors and jurisdictions.

Contagion effects: financial contagion and reputational risk

- Fin was able to take on huge risks from its expanding credit derivatives business without any capital requirement due to the fact that it was outside the scope of supervision. However, the materialisation of these risks caused severe consequences on the whole group including Ins.
- Ins was exposed to the operations of Fin indirectly through intra-group transactions and exposures within the group. The liquidity problems at Fin and the catastrophic windstorm reduced the capacity of Rein and as a result, jeopardised the capital adequacy position of Ins.
- Although Ins still met its regulatory capital requirements, the reputation of the group and its brand was adversely affected by problems in Fin. The sudden spike in surrenders may place Ins under further liquidity stress.

Financial position

- It can be difficult for supervisors to assess the capital adequacy at the group level due to unknown risks being taken by Fin. Supervisors may find it difficult to obtain information, for example on intra-group transaction and exposures, needed to monitor non-regulated entities within the group appropriately. Without sufficient information, supervisors do not have a comprehensive understanding of the activities taken at the non-regulated entities level i.e by Fin until it is too late.
- The presence of intra-group transactions and exposures between the regulated and non-regulated entities within the group made it difficult for supervisors to assess the adequacy of capital at Ins.

Supervisory reach

- As non-regulated entities (Fin, Hold) are not directly supervised or regulated, it would be difficult to apply supervisory measures on such entities. For example, it would be difficult to ensure fit and proper requirements of the board of Hold are met.
- Given that Fins and Hold are not subject to the same reporting requirements as Ins, it would be difficult for supervisors to obtain appropriate, reliable and timely information on the group as a whole.
- Since Fin is located outside the jurisdiction of the home supervisor, information on Fin that may be material to the group's operation can only be accessed through interaction with foreign supervisors. Close cooperation is therefore very important under these circumstances.

Agenda 3 – Supervisory measures
(Note: Items in bold are the Key Features in the Guidance paper on treatment of non-regulated entities in group-wide supervision)

1. 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. The operations of non-regulated entities such as Fin should be well understood by insurance supervisors, and the risks borne by these entities should be properly assessed. Supervisors should also understand the rationale behind the choice of certain organisational structures (such as the setting up of Fin) and the consequences these may have on the effectiveness of supervision of the group as a whole and of the insurance legal entity, Ins.

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. The involved supervisors should assess the exposure of regulated entities such as Ins to both non-operating holding companies (Hold) and non-regulated operating entities (Fins) which may arise from intra-group transactions and exposures.

3. Assessment of capital adequacy on a group-wide basis should have regard to risks arising from non-regulated entities. Although the management accounts of Rein were reviewed and used to arrive at a decision with respect to Ins's capital adequacy by Supervisor A, it should also assess the capital adequacy of the group as a whole. Supervisor A should establish understanding on the risks assumed by Fin by communicating with the respective sector supervisors in Jurisdiction B and using the indirect approach through Ins to access information regarding Fin's operations. A requirement for Fin's risk to be modeled could be imposed to determine the appropriate group capital requirement with respect to this entity. Supervisor A should communicate with Supervisor C to gain reliable information on Rein's capital adequacy. Minimally, these actions would have been required for Supervisor A to assess the capital adequacy of the group. In addition, Supervisor A could limit the level of participation in the non-regulated entities by, for example, not taking into account the participation in Fins when calculating the group capital adequacy. The involved supervisors should also consider imposing the same capital requirements on activities that have similar characteristics as insurance (e.g. the CDS underwritten by Fin) that would be imposed to these activities were they conducted through insurance contracts.

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**. The fitness and propriety of Hold's board was misleading in that it deceived Supervisor A, and failed to prevent poor accounting practices. The activities carried out by Supervisor A to assess the fitness and propriety of the board and senior management are not mentioned; however, communication with Supervisor B may have raised concerns for Supervisor A regarding the Board's fitness and propriety. Supervisor A should assess the fitness and propriety of the significant owners and key functionaries of the group in its capacity as the group-wide supervisor. Since Hold is a non-regulated holding company, Supervisor A should also assess compliance with corporate governance requirements of Hold. Activities that some supervisors use to assess a board's fitness and propriety include obtaining character references; making inquiry regarding criminal record and/or disciplinary action taken against board members with respect to professional misconduct; and evaluating the experience and expertise of board members to ensure that the board collectively has sufficient expertise to understand the risks assumed by the group.

Supervisor A should also assess the risk management and internal controls on a group-wide basis. This would have revealed the potential lines of contagion within the group. An assessment of the group internal controls would identify whether the group has sound reporting and accounting procedures, sound monitoring and management of intra-group transactions. For example, the supervisor would have detected that Fin had down-streamed capital (obtained from an inter-company loan from Ins) to finance a reinsurer formed for the purpose of providing reinsurance coverage to Ins. Further, Fin's exposure to the reinsurer through significant inter-company loans would have been surfaced. The internal control of the group surrounding financial reporting or accounting appeared to be weak given the accounting violations. Such poor quality of risk management and internal controls which do not match the group-wide risk profile and its structure may necessitate the supervisor to impose further regulatory and supervisory requirements such as imposing additional capital requirements.

5. Appropriate supervisory reporting and disclosure requirements should be established to allow for adequate transparency of group structures and operations. Supervisor A should perform more in-depth analysis in a number of areas. It is unknown whether the omission was as a result of insufficient skills or lack of information. Supervisor A had the authority, from a legislative perspective at least, to carry out group-wide supervision by reason of it having the legislative ability to use the follow-up/indirect approach. It should exercise its supervisory authority to obtain timely, appropriate and reliable information on the activities of non-regulated entities such as Fin and Hold through Ins. However, it should be aware that it might still not have access to such information if Ins itself does not have access to the information (for example due to the management of Fin or Hold being uncooperative), or if Ins inadvertently limit or manipulate the information sent to the insurance supervisor. In such circumstances, cross-border supervisory cooperation would be important to obtain the necessary information.

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. Supervisor A will be more effective if it communicates with the relevant supervisors in the respective jurisdictions. Such cooperative relationships may be facilitated through both formal (memorandum of understanding, supervisory colleges, mutual recognition agreements, etc.) or informal means (allowed by information gateways within legislation allowing the sharing of confidential information for regulatory purposes, etc.).

7. The scope of the group-wide supervision framework should be flexible enough to capture emerging new risks from non-regulated entities. Groups like Hold may undertake new activities or move into new markets or set up new entities that are on the edge of, or outside of the scope of supervision. The involved supervisors should therefore ensure that the approach to non-regulated entities should be flexible and pragmatic to ensure that the scope of supervision remains appropriate.

8. Risk mitigation measures should be considered as a possible option in the treatment of non-regulated entities. Such measures may involve ring-fencing. If Supervisor A deems that the additional capital requirements with respect to the non-regulated entities might not be sufficient to protect policyholders or that the information on non-regulated entities is unreliable, other risk mitigation measures could be considered such as forbidding dividend distribution from Ins to Hold or to ring-fence the insurance portfolio of Ins.