

14th August, 2013

GFIA response to IAIS' public consultation on the Issues Paper on the Supervision of Cross-Border Operations through Branches

General comments

The Global Federation of Insurance Associations (GFIA) through its 35 member associations represents insurers that account for around 88% of total insurance premiums worldwide. The IAIS Issues Paper on Supervision of Cross-Border Operations through Branches has been released for public comment following numerous rounds of comments by Members and Observers, and a succession of editorial revisions which have resulted in progressive improvements in the draft paper. A number of GFIA's suggestions have been addressed, including in the most recent version of the paper. Overall we believe the Issues Paper now provides a useful account of current practices in supervising branches.

To date, while this workstream has gathered extensive survey results and other information with respect to branches, the record is devoid of any empirical information about subsidiaries and other legal forms and the issues which they pose for supervisors. In order to draw meaningful conclusions about the branch structure, it is necessary to compare it with alternative forms of legal entity by developing comparable factual information about such entities, e.g. subsidiaries, joint ventures, etc.

Especially where the paper makes assertions that there is a link between form of establishment and policyholder protection and financial stability, the paper is drawing conclusions without having enough material to build on. The literature states that from a supervisory perspective neither branches nor subsidiaries are clearly preferable, and there is no empirical data regarding how form of establishment impacts policyholder protection and (local or global) financial stability. From what we can learn from the singular case study examined, problems arising from branch supervision are best mitigated by enhanced supervisory cooperation and communication.

We welcome that the paper dedicates a section to commitments made under the General Agreement on Trade in Services (GATS) and the OECD Code of Liberalisation of Current Invisible Operations. This is important. A supervisor's ability to set requirements on the legal form an entity under its supervision may take is bound by its jurisdictions' financial service commitments. Given the importance of these commitments, we would like to see these considerations reflected more widely throughout the paper. In particular, every time reference is made to supervisors specifying legal form we believe reference should be made to a jurisdiction's trade commitments, i.e. the language 'if not in violation of a government's international trade commitments' should be added to the text.

The paper contains a detailed explanation as to the circumstances in which the a prudential carve out can be invoked; thereby explaining the circumstances in which a country can legitimately choose to take measures irrespective of financial service commitments made as described in the GATS. This is factually correct; however, we think it is important that, alongside this, the paper makes reference to the seriousness of a country invoking the prudential carve out. We would not want to see it being applied without justification, as this would undermine the value and importance of jurisdictions' international financial service commitments.

Although the improved language used in the current draft of the paper has removed much of the perceived bias seen in earlier drafts we still believe the paper would benefit from a more balanced and empirical foundation. The literature review cites Cerutti, et al. (2007), for the proposition that bank "subsidiaries are more common in jurisdictions where political and economic risks are high so as to isolate the group from these risks" (para. 7), whereas Cerutti, et al. (2007), actually write "when it comes to risks stemming from possible government intervention and other major political events, parent banks are more likely to operate as branches" (p. 4). The preference of companies for establishing branches in countries posing political risk is supported by other studies and is not inconsequential¹. Developing countries are more likely than developed countries to pose political risk (particularly direct or indirect expropriation), but they are also more likely to be underserved². The freedom to establish branches encourages companies to operate in markets where insurance is most needed, benefiting households and businesses and contributing to economic growth and development. A bias toward subsidiaries may inadvertently discourage investment and hamper growth in these markets. Clearly, this is not the intent of the IAIS.

The paper would also benefit from clarification of whether the issues identified relate to events that have actually occurred and resulted in customer detriment, or are perceived issues that might conceivably arise. Indeed, there are considerations referred to in the paper, such as access to diversity of covers and protection, which could be better fulfilled by branches of parents with larger and better diversified balance sheets for reinsurance and commercial lines, than by a standalone subsidiary. This should be reflected in the overall tone and conclusions of the paper.

Given the statement in the Issues Paper that "In the future the IAIS should consider undertaking further work to more fully understand how cross-border operations through branches are supervised," and in light of our remaining concerns on the current paper, it is very important that a very high standard be applied, and further work, if any, must 1) preserve optionality for companies to choose their form of operation 2) include a cost benefit analysis of any recommendations; 3) be neutral, balanced and supported by

¹ See: Dell'Ariccia, Giovanni; Marquez, Robert, "Risk and the Corporate Structure of Banks", *Journal of Finance*, vol. LXV, no. 3, pp. 1075-1096, June 2010.

² For a comprehensive review of the impact of insurance on development, see: Outreville, J. Francois, "The Relationship Between Insurance and Economic Development: 85 Empirical Papers for a Review of the Literature", *Risk Management and Insurance Review*, vol. 16, no. 1, pp. 71-122, 2013.

factual record and empirical research and 4) include work regarding subsidiaries, joint ventures, and other forms of operation when drawing conclusions.

Paragraph-specific comments

Paragraph 4: Although the supervision of cross-border services is supposed to fall outside the scope of this paper, the subsequent text includes a number of references to cross-border services without a sufficient database to allow for reliable conclusions compared to branch structures (e.g. Paragraphs 22, 25, 92 and Annex).

Paragraph 7: Cerutti et al. (2007) state that “subsidiaries are more common in jurisdictions where political and economic risks are high so as to isolate the group from these risks.” However, looking at the literature, what is actually stated is: “Branches are less common in countries with highly risky macroeconomic environments, where parent banks seem to prefer the “hard” shield of limited liability provided by subsidiaries to the “soft” protection of ring-fencing provisions. However, faced with risks stemming from possible government intervention and other major political events, parent banks are more likely to operate as branches. [...] Under those circumstances, banks are actually more exposed as subsidiaries, which typically have higher capital reserve requirements and larger investments in local fixed assets, relative to branches.” This conclusion is consistent with paragraph 11 which states that “Branches may also be the preferred option for operations in jurisdictions with high economic and political risks”.

This reads very differently to the Issues Paper, as it explores some significant downsides to subsidiaries (in this case that they are more exposed in politically uncertain surroundings) and benefits to branches.

Paragraph 13: We welcome the attention given here to commitments in financial services. As mentioned in our general comments, the importance of these commitments should be reflected throughout the paper, where it refers to supervisors setting requirements on legal form. In addition to this, language should be added highlighting the seriousness of a country invoking the prudential carve-out, to avoid supervisors invoking it too liberally and thereby undermining the importance and value of financial services commitments.

Paragraph 61 and 62: The description of supervisors’ ability to require conversion to subsidiary should be limited to measures with a legal basis. The text refers to supervisors requiring foreign branches to convert on a ‘voluntary basis’. This is not a legally-grounded supervisory tool and has no commonly recognised definition; therefore, reference to this supervisory tool provides little clarity on what application of this tool means in practice.

Paragraph 77: This sub-section is now qualified, noting that supervision of branches is no more difficult than that of domestic insurers and subsidiaries and that some challenges may also apply to foreign subsidiaries. We agree with these statements. Nevertheless, use of “possible” in brackets suggests that

most of the challenges identified are theoretical: problems that might arise in the future but have not yet manifested themselves. The paper should make this clear and should consider to what extent, if any, these difficulties affect policyholder protection.

Paragraph 78: It is not clear how gaps in regulation and supervision between home and host jurisdictions are a “challenge” to the supervision of foreign branches. It would be useful to clarify the precise nature of the problem the paper is referring to here. It also says “home supervisors do not have direct supervisory power over branches” However, they sometimes do have such power (as in the EEA over branches of EEA undertakings) and their supervision of the parent undertaking often includes all the undertaking’s activities, wherever they take place, including through branches.

Paragraph 79: Paragraphs 79, 82 and 83 all relate to requirements for foreign branches to hold assets relating to the business that they write. It would be preferable to treat this issue in one place. The paper should take account of the point (touched on in paragraph 79) that requiring an undertaking to hold assets wherever it has a branch means that its aggregate assets are compartmentalised across the world similar to that of a subsidiary. This approach ignores one of the key benefits of branch operations and the fundamental insurance principles around diversification and could significantly and unnecessarily push up (re)insurers’ capital costs, thereby increasing prices. Thus, far from protecting policyholders’ interests, they are damaged by such an approach, to address an unproven problem.

Paragraph 83: This paragraph states that the branch structure might result in assets being transferred from a branch to other parts of the group, as if the host jurisdiction only hosted foreign group operations, but was not the home supervisor of any group. Moreover, this paragraph contradicts paragraph 79, which claims that the branch structure might hinder transfer to the parent (which is actually truer for subsidiaries, as partially noted by footnote 66).

Paragraph 84: This paragraph talks about information asymmetry. It makes the assertion that this applies particularly within the EEA “...where branches of insurers seated in other EEA jurisdiction are not required to report to the host supervisor.” Reporting by foreign branches to host supervisors does not mean that host supervisors are thereby fully informed about the parent, any more than reporting by foreign subsidiaries means they are fully informed about a group. A home supervisor is bound to be better informed about the parent than host supervisors, as an inevitable consequence of their supervisory role. This is no different within the EEA than it is outside. As such, the text could usefully emphasise that any requirement for additional group data would be best met through effective supervisory co-ordination, and duplicative reporting should be avoided.

Paragraph 85: This paragraph says that lack of a branch board of directors may limit the host supervisor’s ability to supervise governance arrangements effectively. This point does not acknowledge that a branch having its own board could materially weaken the controls exerted over the branch by the undertaking’s own board by inserting a new level of governance in the corporate structure. As a branch’s

governance is integral with that of the parent, effective supervision of governance can be achieved through active co-operation between home and host supervisors.

Paragraph 86: This paragraph suggests supervisors may set requirements “where legally permissible”. Reference should be made to international commitments that guarantee the choice of corporate form, to remind regulators that violating international commitments is contrary to international regulatory norms.

We question whether this section is a necessary part of the paper. Paragraph 86 and its footnotes say that it is simply descriptive of the approaches that have been used to supervise foreign branches and “...does not intend to recommend any specific approaches nor should be read that all jurisdictions need to take these approaches.” However, pages 6 to 18 of the Report already describe the regulatory and supervisory approaches to foreign branches of different jurisdictions. All the “possible approaches” in section 5.2 are therefore already set out in detail earlier in the paper. If this section is just summarising earlier, more detailed, accounts, it should appear immediately after sections 2 and 3 and the links between the supervisory approaches it describes and the earlier accounts should be clear.

Paragraph 88: This paragraph suggests strengthening regulatory requirements for branches. While this is certainly possible, it should only be done if the supervisor is fully aware of how protectionist measures may serve to inadvertently fragment insurers’ spread of risk, can increase concentration risk, and can harm global financial stability. A similar point was made in paragraph 82.

Paragraph 89: This paragraph suggests supervisors may set requirements “where legally permissible”. Reference should be made to international commitments that guarantee the choice of corporate form, to remind regulators that violating international commitments is contrary to international regulatory norms.

Footnote 70 is a welcome example of the fact that the relationship between policyholder protection and subsidiarisation is not straightforward. This point could be more clearly reflected in Paragraph 93 where the link between subsidiarisation and policyholder protection is implied to be a positive one.

Paragraph 91: Not only is operation through branches legally protected within the EEA, it is much more widely committed to by jurisdictions through their commitments in financial services, as mentioned in Paragraph 13. This would be a logical place to make the point much clearer that insurers should be allowed freedom of choice of legal form when setting up cross-border operations, which is a choice underpinned by all the above mentioned commitments. Violation of these commitments should not be taken lightly, and this would be an appropriate place to reflect this.

This paragraph also refers to EEA branches as benefiting from “a special privilege”. This use of language is inappropriate. EEA undertakings’ ability to establish branches in other EEA member states arises from the fundamental Treaties establishing the Union and is a natural feature of the Single European Insurance Market. Undertakings establishing branches are subject to home supervision in accordance with EU insurance directives applying in all member states. To view this arrangement as a “special

privilege” suggests that such branches are especially favoured and implies that the “privilege” could, or even should, be withdrawn. The EEA’s treatment of branches is an approach to branch supervision, and should be included in any account of supervisory approaches, but needs more detailed and accurate coverage than is provided by this paragraph.

Paragraph 92: We welcome that the special nature of the reinsurance business is taken into account. Reinsurance is a business dominated by multinational corporations that provide financial protection across all lines of insurance business. Reinsurers often establish branch offices to promote direct contact with local insurance clients and maintain a physical presence in markets around the world in a cost-efficient manner.

Paragraph 93: This paragraph suggests supervisors may set requirements “where legally permissible”. Reference should be made to international commitments that guarantee the choice of corporate form, to remind regulators that violating international commitments is contrary to international regulatory norms.

This paragraph suggests that a host supervisor might require a branch to become a subsidiary “...to mitigate possible threats to policyholders and/or financial stability, taking into consideration the issues highlighted in the previous chapters of this paper.” However, the paper does not suggest that a foreign branch constitutes a threat to either policyholders or an undertaking’s financial stability and nowhere do the issues it highlights suggest this to be the case. If foreign branches do not pose a threat in this way, requiring them to become subsidiaries cannot be justified. This is compounded by the acknowledgement in Footnote 70 that conversion to subsidiaries may harm policyholders. To quote Fietcher et al (2011): “A key observation of the paper is that neither the branch nor the subsidiary structure is obviously preferable in all cases from the financial stability perspective. “

Paragraph 94: We welcome the acknowledgement that tools intended to balance the supervision of branches with that of subsidiaries require an analysis of the practices of supervising branches next to an analysis of supervising subsidiaries. We reiterate that any tools applied to branches are decided on after consideration of the implications of the various alternative forms of establishment.

Paragraph 95: This paragraph suggests that further work should be done on branch supervision. We believe that before the IAIS is in a position to draw any conclusions or make any recommending as to what, if any, additional supervisory tools may be needed for branches, more analytical work is needed. Further work should draw on a larger empirical basis and should include subsidiaries and other corporate forms.

Annex 1: Freedom of establishment and freedom to provide services in the EU

Freedom of establishment: The first paragraph of this annex describes the EU’s provisions for services business. However, it does not provide a similar description of provisions for establishment business,

perhaps surprisingly for a Paper on the supervision of branches, when the supervision of cross-border services is explicitly outside its scope.

Freedom of services: The first paragraph also says that insurers with an establishment in the EEA has a right to provide services to another EEA member state and defines “establishment” as “head-office, branch-office or agent.” In fact this applies only to EEA undertakings. A non-EEA insurer with a branch or an agent in the EEA is not able to carry on business from other member states through its branch or agent on a services basis.

General good requirements: The Annex does not mention that EEA direct insurers carrying on business in other member states on an establishment or services basis are subject to host state rules imposed “in the general good”. Their activities are not therefore entirely devoid of oversight by host supervisors. In this context, the Commission Interpretative Communication is on “Freedom to provide services and the general good in the insurance sector”, not “for the general good...”

Solvency II: The Annex says that the Solvency II Directive provides a comprehensive overview of this point. Of course, the Directive will not be in force until 2016 at the earliest. For the time being, the relevant provisions are set out in the Life and Non-life Directives.