Domestic Systemically Important Insurer ("D-SII") Framework

A. Background

1. In November 2019, the International Association of Insurance Supervisors ("**IAIS**") adopted the Holistic Framework for the assessment and mitigation of systemic risk in the global insurance sector ("**Holistic Framework**"), which took effect from 2020. The Holistic Framework has the following three key elements:

    a) The Holistic Framework related supervisory material is integrated into the Insurance Core Principles, Standards, Guidance and Assessment Methodology ("**ICP**") and the Common Framework for the Supervision of Internationally Active Insurance Groups. It is an enhanced set of supervisory policy measures designed to increase the overall resilience of the insurance sector and help prevent insurance sector vulnerabilities and exposures from developing into systemic risk, through on-going supervisory requirements applied to insurers, enhanced macroprudential supervision and crisis management and planning. Where a potential systemic risk is detected, supervisory powers of intervention will enable a prompt and appropriate response.

    b) The Global Monitoring Exercise ("**GME**") conducted annually by the IAIS aims to assess global insurance market trends and detect the potential systemic risk arising. The GME includes the Sector-wide Monitoring exercise, the Individual Insurer Monitoring ("**IIM**") exercise, collective discussion[1] of the results of the assessment within the IAIS, and reporting to the Financial Stability Board ("**FSB**") and relevant stakeholders.

    c) An implementation assessment, including a Baseline Assessment and a more in-depth Targeted Jurisdictional Assessment assesses whether the relevant enhanced supervisory material is implemented consistently which is deemed to be critical for the Holistic Framework to be effective in assessing and mitigating systemic risk globally.

2. In light of the Holistic Framework, the FSB, in consultation with the IAIS and national authorities, has decided to suspend global systemically important insurer ("**G-SII**")

[1]The collective discussion includes a forward-looking exploration of the assessment of systemic risk in the global insurance sector. This includes a discussion on any identified significant growth in certain markets or activities, or of a specific insurer(s) that shows significant increases or concentrations in activities and exposures. IAIS Members and relevant supervisors will be asked to share their findings on the trends or levels identified within their jurisdiction or at the level of individual insurers with a focus on potentially systemic activities, this discussion will be supported by the outcomes of the IAIS' assessment of the implementation of the Holistic Framework supervisory material.

identification as from the beginning of 2020. In December 2022, the FSB announced its decision, in consultation with the IAIS, to discontinue the annual identification of G-SIIs based on the initial years of implementation of the Holistic Framework for the assessment and mitigation of systemic risk in the insurance sector. The FSB will continue to receive an annual update on the IAIS's assessment of systemic risk at the global insurance sector-wide, possible concentration of systemic risks at the individual insurer level, and supervisory responses to any identified risks.

B. Objectives

3. ICP 24 as published by the IAIS stipulates the matters that supervisors should have in place with respect to macroprudential supervision, as part of the overall supervisory framework. Within macroprudential supervision, supervisors are expected to identify, monitor and analyze market and financial development among other environmental factors, where necessary, and address the vulnerabilities and the build-up of systemic risk at the individual or the sector-wide level. Supervisors should also have an established process with a total balance sheet approach to assess the potential systemic importance of insurers.

4. The "Key Attributes of Effective Resolution Regimes for Financial Institution" ("**KA**") issued by the FSB in October 2014 required any insurer that could be systemically significant or critical if it fails, to be subject to a resolution regime consistent with the FSB's KA.

5. In Hong Kong, the *Financial Institutions (Resolution) Ordinance* (Cap. 628) ("**FIRO**") is an ordinance that establishes a regime for the orderly resolution of financial institutions with a view to avoiding or mitigating the risks otherwise posed by their non-viability to the stability and effective working of the financial system of Hong Kong. For the insurance sector in Hong Kong, FIRO can be applied to an authorized insurer that is a G-SII or a designated within scope financial institution of which the Insurance Authority ("**IA**") is designated by the Financial Secretary by notice published in the Gazette[2] as the resolution authority.

6. To be consistent with international developments and policy measures under the Holistic Framework promulgated by the IAIS, the IA has established a framework to classify D-SII in Hong Kong and to address the risks they pose to the stability and effective working of the financial system of Hong Kong. The classified D-SII(s) will be recommended to the Financial Secretary for designation as a within scope financial institution under section 6(1)(a) of FIRO, with the IA being the resolution authority ("**FIRO Designation**"). Under FIRO, the Financial Secretary must consult the IA and the other resolution authorities before making the FIRO Designation.[3]

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[2] Refer to section 6(1)(a)(ii) of FIRO.
[3] Pursuant to section 6(3) of FIRO.

C. Scope of Application

7. The D-SII framework aims to classify insurer(s) with such domestic systemically importance that their failure will cause significant disruption to Hong Kong's financial system. The IA will assess all locally incorporated authorized insurers carrying on general insurance business and long term insurance business under the *Insurance Ordinance*, (Cap. 41) ("**IO**"). For insurers incorporated outside Hong Kong, other than designated non-HK insurers as defined under the new section 3B of the IO, their respective operations by their Hong Kong branches will be assessed under the D-SII framework as well.

8. Since March 2021, the IA has been given group-wide supervision powers and may directly regulate and supervise insurance groups of which the IA is appointed the group supervisor. Pursuant to section 95C of the IO, the IA may designate an insurance holding company incorporated in Hong Kong as a Designated Insurance Holding Companies ("**DIHC**"). DIHCs will also be subject to the D-SII framework from a consolidated perspective.

D. Outline of the process for classifying D-SIIs

9. The D-SII classification framework will be a two-step process, quantitative and qualitative assessment.

<u>First step: Quantitative Assessment</u>

10. The IA has made reference to the IIM Exercise and has modified it into a methodology that is pragmatic and suits the domestic context of Hong Kong. The quantitative assessment methodology is indicator-based using both absolute and relative basis to assess insurers' (**which includes authorized insurers, the Hong Kong branch of authorized insurers and DIHCs**) systemic importance to the Hong Kong financial market. The indicators and its respective weightings are as follows:

	Factor	Weights	Indicators	Weights
A.	Size	40%	Total assets	40%
B.	Substitutability	25%	Total market share (General business/Long Term business) OR Market share in key business lines	25%
C.	Interconnectedness	25%	Derivatives	12.5%
			Total borrowings	12.5%
D.	Liquidity	10%	Short term funding and repurchase agreement liabilities	10%

Size

11. The Hong Kong insurance market is generally saturated with intense competition, although there are specialized insurers and market segments dominated by a few insurers. That said, insurers reaching a certain size are more susceptible to bring instability or threat to the financial system in Hong Kong. Generally speaking, the larger the insurer in terms of assets, the higher the likelihood that its failure would adversely affect the stability and effective working of the domestic financial market. The data collected under IIM Exercise are mostly specific assets size related. Thus, asset size is a key measure of systemic importance with the highest weighting and is the sole indicator under this factor.

Substitutability

12. An insurer with a bigger market share could translate to a higher risk of disruption to the functioning of the insurance market if the insurer were to fail, given the higher concentration risks. The Substitutability factor will be based on market share. Certain insurers in specific market segments with complex products that are difficult to be substituted in a timely manner will be assessed separately, regardless of the insurers' overall market share. This is because the non-substitutability of these business lines could lead to temporary interruption of the overall financial market. For example, in Hong Kong, it is considered that the failures of insurers operating in market segments such as mortgage insurance and credit insurance will create a bigger impact to the financial market in terms of substitutability.

13. In terms of assessing substitutability factor of DIHCs, such assessment will be based on the market share of entities within the Crisis Management Group ("**CMG**") of the DIHCs.

Interconnectedness

14. An insurer's extent and nature of linkage to the wider financial markets entails that it could have a bigger spillover effect. The higher the linkage, the more adverse impact it will bring if the insurer is in distress. Under interconnectedness factor, the IA will have a first screening to identify insurers with important function where its default can have a spillover impact to the stability of the financial system in Hong Kong. The important functions are as follows:

    a) Insurers which are nominated within scope of collective discussions under GME.
    b) Insurers which are linked to a Domestic Systemic Important Banks ("**D-SIB**") identified by the Hong Kong Monetary Authority or other domestic systemically

important financial institutions with evidenced importance to such entity in Hong Kong[4].

c) Insurers' business that has a direct explicit linkage to the financial system in Hong Kong[5].

15. Subsequent to the first screening, all insurers will be assessed on its linkage to the wider financial market based on the below indicators:

a) Derivatives

Insurer's total gross notional amount of outstanding over-the-counter derivatives will be assessed under this indicator. Higher holdings of derivatives indicate a higher connectedness to other financial markets which pose higher systemic risk.

b) Total borrowings

Insurer's total borrowings will be assessed under this indicator. This indicator is a proxy to capture the financial interconnectedness of an insurance company with other financial institutions. The greater share of an insurer's borrowing could imply a greater impact of an insurer's failure on the financial system. Total borrowings can include any funding raised from the market such as loans, and all principal raised from issuing debt instruments are included to better capture the insurer's interconnectedness to the wider financial market.

Liquidity

16. Liquidity factor aims to assess insurers' liquidity risk. If insurers' liquidity risk materializes, it could trigger a downward spiral in the financial markets. When insurers have to sacrifice asset values to satisfy outflows through selling additional assets, it could aggravate the systemic impact and even transmit to other parts of financial markets and the real economy. The liquidity factor will be assessed based on how much an insurer's liquid assets are needed to cover its liquidity needs[6].

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[4] The insurer must constitute 20% of the D-SIB's shareholder equity on a 2 years average.

[5] Class of businesses such as mortgage insurance or export credit insurance, etc. are considered to have significant linkage to the wider financial market which the non-functioning of these businesses could potentially have contagion risk.

[6] Liquidity needs can be short term funding, repurchase agreement which include any debt or debt like instruments maturing in the next 12 month as well as repurchase agreement transaction liabilities.

<u>Second step: Qualitative assessment</u>

17. The summation of scoring from Size, Substitutability, Interconnectedness and Liquidity factors within the quantitative assessment sets out to differentiate whether an insurer can be considered as a D-SII. The IA will then overlay a qualitative step to assess any mitigating factors that are not of a quantitative nature and are not well captured by the mechanistic quantitative analysis. In this step, the IA will consider the matter against the threshold stated in FIRO, namely whether "*a risk could be posed to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, should the [D-SII]….cease to be viable*." The qualitative assessment takes into account all factors, without limitation, whether there is sufficient backstop immunizing any potential contagion risk and any representations received from the insurer which is under consideration, the existence of any government guarantee and/or sufficient contingency funds to reduce such systemic risks to the Hong Kong financial market. Both quantitative and qualitative assessment will be considered in deciding whether the insurer ought to be classified as a D-SII and to be designated under FIRO.

E. Assessment and Supervisory Approach

18. The IA could cooperate and coordinate with other financial regulators to gain additional perspectives on the potential change in the risk landscape in the evolutions of other financial markets. Once the D-SII is designated under FIRO ("**FIRO designated D-SII**"), the IA being the resolution authority, will devise strategies for securing an orderly resolution of the FIRO designated D-SII by exercise of FIRO powers as well as any applicable powers under the IO, and conduct resolvability assessment to determine whether there are any impediments for orderly resolution.

19. The IA will consider the relevant systemic risks that pose to the Hong Kong financial market when performing supervision on the D-SII, to ensure there is sufficient buffer in the capital reserves to reduce the likelihood of non-viability. In addition, the IA will take into account the systemic risk when reviewing the Own Risk and Solvency Assessment report required under GL21: Guideline on Enterprise Risk Management and GL32: Guideline on Group Supervision for insurance groups.

20. The IA adopts a forward-looking approach to anticipate the insurer(s)'s position for the next year during the process of classifying a D-SII(s). In this process, the IA will take into consideration any emerging developments of the individual insurer's business operations as well as trends in the insurance sector. For those who are close to being classified as D-SII, the IA will monitor any emerging exposures, and engage in early dialogue in order to set up recovery plans which will interact with Pillar 2 of Risk Based Capital ("**RBC**") Regime, if those plans are not yet in place.

F. Assessment Procedure

21. The D-SII framework starts with data collection. The IA will use data which is already collected as part of the existing reporting requirements. The data collected will be used to process the D-SII quantitative assessment as mentioned in Section D and subsequently the qualitative assessment. The IA could from time to time solicit additional input from insurers to supplement the assessment. When the Financial Secretary designates an insurer as a within scope financial institution under FIRO, he/she may do so by notice published in the Gazette. The IA will also issue a public announcement regarding such FIRO Designation.

G. Implementation

22. The IA will conduct the assessment annually. However, it is not implied that the outcome of the assessment is expected to change regularly. Instead, the methodology is designed in such a way that the result should be relatively stable over time. An annual assessment is deemed to be appropriate to allow the IA to closely monitor developments over time and to identify in a timely manner which insurers might need to be added, or rather be removed, from the list of insurers deemed systemically relevant. The annual assessment also allows the IA to closely monitor insurers that come close to becoming systemically important in Hong Kong and establish a range of policy measures to reduce their probability of, as well as the extent or impact of their failure.

23. The IA notes in this regard that international practices are evolving. As such, the IA will continue to observe closely international developments in the proposed framework for assessing the systemic relevance of insurers. The IA will review the proposed methodology according to the IAIS's Holistic Framework. This should enable the IA to capture developments within the insurance sector and to reflect evolving international and peer practices in assessing the systemic importance of insurers.