November 2017

GFIA response to the IAIS on ICS version 1.0 for extended field testing

Summary

GFIA appreciates the opportunity to comment on ICS version 1.0 for extended field testing.

The development of the ICS is an important development in international insurance prudential regulation and, as such, requires a thoroughly considered approach. GFIA welcomes the insights that the IAIS has provided in the public documentation as to why particular decisions have been taken following the 2016 field testing, and we strongly encourage the IAIS to continue to do this, as it allows stakeholders to understand and more deeply engage with the IAIS process, and provide more tailored input. The IAIS has sensibly adopted an iterative process for the development of the ICS, and we acknowledge that version 1.0 for extended field testing is one step along the way to an international standard.

GFIA has been a strong and long-standing proponent of a measured approach to ICS development, given the size and ambition of this project. However, we are very concerned about how ambitious the IAIS has been in the setting of its timeline for this project. Version 1.0 for extended field testing retains significant optionality, leaving a large number of very important aspects to be determined before the IAIS' deadline of November 2019. In particular, there are still a large number of issues surrounding capital resources and taxation that remain outstanding as well as the key issue of balance sheet valuation which remains work in progress with more investigation and testing needed. We recommend that the IAIS reconsiders its ambitious timeline and implementation objectives, to ensure that the standard that is adopted is fit for purpose.

GFIA's view is that local regimes which are consistent with the ICS framework should ultimately be recognised as a suitable implementation of the ICS. In GFIA's view, it is key that a situation where companies have to manage business on the basis of two or more parallel, potentially different and conflicting regimes, should be avoided. We understand the IAIS' view is that the ICS is a group-wide capital regime targeting IAIGs. However, in practice, GFIA members are concerned about the implications of the ICS for the regulation of legal entities, and the risk of inadvertent overlap in the purpose and coverage of the ICS. In light of this, and consistent with the IAIS' statement that the ICS is a minimum standard that jurisdictions can build on or adjust, ICS Principle 10 should be amended accordingly. Also related to the local regime approach is the need to give serious consideration to the acceptance of an aggregation approach to calculating group capital. The ICS should allow jurisdictions that take a strong legal-entity approach to capital and do not require financial statements on a consolidated basis to use bottom-up aggregation to devise a group capital standard. Grandfathering and transitional measures should also be considered as soon as possible.

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The ICS' valuation of liabilities is of critical importance to GFIA members. In GFIA's view, the valuation approach needs to work across diverse geographic markets, not conflict with existing regulatory or accounting valuation bases, accommodate local market conditions, incentivise good ALM practices where appropriate, and strike the right balance between the complexity of the calculations, and the need to capture the link between assets and liabilities in a way that avoids artificial balance sheet volatility. Some GFIA members believe that the valuation should reflect the actual holdings of assets on the liabilities side. Some members believe that the ICS should allow the use of a GAAP Plus accounting approach. Other GFIA members believe that a reference portfolio approach should be used. GFIA´s view is therefore that the IAIS should propose two MAV valuation bases, a valuation based on actual assets and liabilities, and one based on a reference portfolio. GFIA considers that the practical way forward would be to recognise local regimes that are equivalent with the ICS as its practical implementation.

Another central feature of the insurance business model that needs to be explicitly and appropriately recognised in any capital framework is the use of diversification and risk-mitigation techniques, including re-insurance, profit-sharing and hedging. These elements are key to achieving the envisaged risk-sensitivity feature of the ICS framework. Diversification and risk mitigation are fundamental aspects of the insurance business and are also closely linked to ICS Principle 6 on promoting sound risk management by IAIGs.

GFIA does not support the inclusion of margin over current estimate (MOCE) within the ICS. In our view, a MOCE is unnecessary to achieve the risk-based nature of the ICS, as it is a theoretical form of prudence, not meant to cover any policyholder liabilities. If a MOCE is introduced, it should not be part of insurance liabilities, to avoid double-counting of risk and over-calibration of the capital requirement. Rather than focussing on the development of the MOCE, we would like the IAIS to use the data collected during the 2017 field testing to set more appropriate stress levels in the different modules of the ICS.

The recognition of internal models (partial and full) is a crucial issue for GFIA members. We agree with the IAIS that the ICS should include an appropriately-calibrated standard method, and support the development of a standard formula that has the right balance between risk-sensitivity and simplicity, promoting ICS Principle 8. Local regimes which are consistent with the ICS framework should ultimately be recognised as a suitable implementation of the ICS. But we also welcome the IAIS' plans to consider other methods such as internal and external models, and variations of the standard method, to the extent that a level playing field across jurisdictions is ensured, and we would support the IAIS giving serious consideration to an aggregation approach as a variation of the standard method. GFIA encourages the IAIS to allow for internal models (partial and full) to be used to determine risk-sensitive capital requirements, where permitted under local regulatory regimes or by local regulators. Internal models can often provide insurers and supervisors with good insights into a firm's idiosyncratic risks and therefore promote sound risk management, in line with ICS Principle 6. When considering the recognition of internal models, GFIA would encourage the IAIS to ensure that the introduction of internal models includes a sufficient preparation period that creates a level playing field across jurisdictions. Where firms are exercising the option to use internal models, any approval process should foster comparability, and not impose an excessive burden on IAIGs. The IAIS should ensure the ICS is sufficiently flexible to allow the continued use of internal models that meet high standards, and therefore avoid the situation where IAIGs must simultaneously run a model approved under the ICS as well as a model approved under a jurisdictional regime.

Finally, GFIA noted in its comments on the 2016 consultation that the ICS confidence level had been set at 99.5% VaR, without the IAIS asking for comment or making any reference to field testing. GFIA asked then that, if the IAIS proposes to decide on the ultimate confidence level for the ICS, IAIS asks for stakeholder comment on the issue before making any decision. We reiterate that request.

GFIA would like to thank the IAIS for considering our comments, and we look forward to ongoing engagement with the IAIS.

Additional comments

Valuation

The valuation of liabilities is of critical importance to GFIA members. The framework must work across diverse geographic markets, not conflict with existing regulatory or accounting valuation bases, and towards comparability of MAV and GAAP Plus. Achieving comparability of MAV and GAAP Plus valuation bases is a long-term project, and we appreciate the effort that the IAIS has already invested into investigating potential areas of comparability between the two valuation approaches. Significantly more time and analysis are required to allow for a better understanding of if and how the two valuation approaches can produce more comparable outcomes. Further, we would note that an appropriate transition period will be required as is necessary for any fundamental change.

GFIA considers that the approach to valuation needs to work across diverse geographic markets, accommodate local market conditions, incentivise good ALM practices where appropriate, and strike the right balance between the need to capture the link between assets and liabilities in a way that avoids artificial balance sheet volatility, and the complexity of calculations. Some GFIA members believe that the valuation must reflect the actual holdings of assets on the liabilities side. Some members believe that the ICS should allow the use of a GAAP Plus accounting approach. Other GFIA members believe that a reference portfolio approach should be used.

Given that preferences in this respect reflect the diverse nature of insurance business – for example long-term life insurers' balance sheets are likely to be subject to artificial volatility if the valuation approach does not align with their ALM, whereas the shorter duration of P&C/non-life insurers' liabilities means such artificial volatility will be less pronounced - GFIA's view is that the IAIS should propose two MAV valuation bases, one a valuation reflecting the link between actual assets and liabilities, and one based on a reference portfolio. This diversity in valuation approaches is one of the key reasons GFIA considers that the practical way forward would be to recognise local regimes that are equivalent with the ICS as its practical implementation.

GFIA agrees with the three-segment approach to the definition of IAIS base yield curves for life insurers. Given the long-term nature of insurance business, excessive volatility in insurers' balance sheets caused by short-term market fluctuation should be avoided, and countercyclical mechanisms considered to reduce the pro-cyclicality of short-term items. The placeholder reinvestment assumption in the field testing is too low and needs to be increased.

In relation to the margin over current estimate (MOCE), we reiterate our view that it is not clear why a MOCE is necessary. We are concerned that inclusion of margins for prudence duplicates the allowance for uncertainty that will already be included within the ICS valuation basis and capital requirements, resulting in over-estimation of liabilities. Furthermore, the development of a MOCE that is comparable and consistent, and therefore aligned with the objectives of the ICS, is a very challenging task, and the inclusion of MOCE is not a pre-condition for ICS development, but a driver of further complication. We do not consider it a compelling argument for the MOCE that reference to it exists in two standards in ICP 14. The IAIS intends to bring about extensive change to international prudential standard setting through the ICS, and to do this the IAIS needs to recognise where there is a disconnect between existing ideas and the ICS' objectives. In fact, according to the IAIS, ICP 14 is due to be reviewed following finalisation of the ICS, so its current provisions shouldn't be considered as limitations to the ICS development.

While GFIA does not support the inclusion of MOCE within the ICS, if it is introduced, it should not be part of insurance liabilities, rather the entire amount should be classified in Tier 1 capital resources without limits.

Capital resources

While GFIA appreciates that the IAIS is taking an iterative approach to the development of the ICS, and that it cannot address all issues at once, GFIA is concerned about the lack of progress on capital resources made in ICS version 1.0 for extended field testing. This lack of progress from 2016 field testing means that there are a large number of issues surrounding capital resources that remain outstanding, and therefore the timeframe for their determination should be reviewed accordingly.

GFIA would like to make the following comments in relation to capital resources:

- It is not appropriate to compare the net assets under MAV or GAAP Plus balance sheets with net assets under accounting balance sheets as these are two distinct valuation bases.

- The treatment of capital resource instruments should be consistent: currently, the proposals treat Tier 1 and Tier 2 debt instruments at market value as a liability on the balance sheet, but at book value as capital.

- Current encumbered asset proposals do not allow for the underlying liquidity/transferability of funds at the balance sheet date and, as such, do not reflect the fungibility of such excess assets. The key considerations for determining the eligibility of encumbered assets should be fungibility, liquidity and transferability. In 2017 field testing, the deduction of encumbered assets from Tier 1 is punitive, even if recognised in Tier 2.

- With regard to amortisation criteria, the current criteria for debt instruments can lead to very abrupt changes in value as step-up dates are reached. We would recommend a more refined approach.

- It is crucial that capital resources include legal, contractual and structural subordinated debt.

- The setting of limitations (such as the ratio of Tier 1 Limited capital to Tier 1 Unlimited) could lead to pro-cyclicality concerns.

- Transitional measures should be considered sooner rather than later, as the uncertainty would create difficulties in making management decisions. The recognition of subordinated loans issued before the application of ICS is very important to ensure the smooth transition to a new regime.

- We appreciate the IAIS' consideration of the unique characteristics of mutual insurers' capital resource requirements. Surplus notes and Kikin are the most readily available sources of capital for mutual insurers in a number of jurisdictions.

- We suggest that the IAIS should take a more principle-based approach to the identification of capital resources. The shock-absorbing capacity of the instruments would then be determined based on the economic reality and the practical implementation of capital funding methods in each jurisdiction, so that the IAIGs' shock absorbing capacity using those methods could be appropriately evaluated on a going-concern basis.

- To ensure fairness in regulatory/supervisory practices regarding the recognition of capital resources, the requirements/restrictions on the applicable supervisory regime should be broadly considered. If new capital-raising financial instruments are developed, the tier of these new instruments should be determined based on their similarities to existing financial instruments.

Subordination

GFIA supports the IAIS giving further consideration to the recognition of structurally subordinated debt, in particular around the expectation to repurchase or redeem and features that can accelerate repayment outside wind-up. We believe that structural subordination allows senior debt issued by non-operating insurance holding companies to meet the criterion that the instrument is subordinated to policyholders, and qualifies as capital resources, as senior holding company investors will not be able to access funds down-streamed into regulated entities without the regulator's consent.

Mutual IAIGs

The primary capital resource for IAIGs is equity (share capital), which mutual IAIGs are unable to issue as they are owned by their policy holders and not shareholders. The definition of qualifying capital resources in the ICS therefore needs to recognise and accommodate the unique needs of mutual insurance companies, and we appreciate the IAIS' willingness to consider whether financial instruments issued by mutual IAIGs should qualify as Tier 1 capital.

As mutual IAIGs are unable to issue common shares, surplus notes and foundation funds (Kikin) remain the most readily available sources of capital to meet a mutual insurer's near-term capital needs in a number of jurisdictions. Surplus notes have unique equity-like features, they are deeply subordinated to all policyholders and non-regulatory capital creditors and require supervisory approval prior to issuance, redemption or distribution. These features ensure that surplus notes provide loss-absorption on a going concern basis, with a requirement for supervisory approval prior to redemption making that instrument able to be considered perpetual. Kikin can offset losses as a net asset item on balance sheets, and therefore also provide loss-absorption on a going concern basis. In light of a mutual company's inability to issue common shares – the major source of unrestricted Tier 1 capital in the ICS - we believe it is necessary to recognise surplus notes and Kikin as Tier 1 capital in order to preserve a level playing field with non-mutual insurance companies.

Non-paid up capital resources

Non-paid up capital should form part of capital resources, subject to safeguards. Non-paid up capital is an existing source of funding for certain insurers, and a form of Tier 2 capital in some regulatory regimes.

Prior supervisory approval for redemption at maturity and consideration of lock-in features

In GFIA's view, supervisory approval processes provide substantially the same economic effect as a contractual lock-in clause. Tier 2 capital resources absorb losses at gone-concern basis, and need not meet the ICS capital requirement for its repayment or redemption. We believe that meeting the MCR in each jurisdiction is enough for the repayment or redemption to assure its loss absorbance ability.

Capital composition limits

GFIA considers that the setting of limitations, such as the ratio of Tier 1 Limited capital to Tier 1 Unlimited capital could lead to procyclicality concerns.

Capital requirements

GFIA agrees with the IAIS' ICS Principle 4 that all material risks to which an IAIG is exposed should be reflected in the ICS. GFIA agrees that the ICS should include a sophisticated standard method that avoids artificial balance sheet volatility and reflects material risks. Local regimes which are consistent with the ICS framework should ultimately be recognised as a suitable implementation of the ICS. We also welcome the IAIS' plans to consider other methods such as internal and external models, and variations of the standard method, and we would support the IAIS giving serious consideration to an aggregation approach as a variation of the standard method during the field testing of ICS version 2.0.

GFIA encourages the recognition of internal models (full and partial) in the ICS, to capture the idiosyncratic risks of firms, and to promote sound risk management, in line with ICS Principle 6. We do not consider the standard method, as set out in ICS version 1.0 for extended field testing, can always fully and adequately capture the risks faced by firms. When considering the recognition of internal models, GFIA would encourage the IAIS to ensure that the introduction of internal models includes a sufficient preparation period that creates a level playing field across jurisdictions and the ICS must be sufficiently flexible to allow the continued use of existing internal models that meet high standards. Where internal models are already in place under risk-based regulatory frameworks, and align with the ICS principles, such existing models should be recognised as the implementation of the ICS in that jurisdiction, rather than requiring IAIGs to run an ICS internal model alongside existing internal models under jurisdictional regimes. Where insurers exercise the option of internal models, any model approval process must foster comparability, and must not impose an excessive burden on IAIGs.

Risk Mitigation

GFIA appreciates that the IAIS has revisited the approach that was used in the 2016 field testing, to explore alternative approaches to better recognise the regular, well-governed renewal of risk mitigation techniques. It is important for risk mitigation measures to be adequately recognised in ICS, as these lie at the heart of the insurance business model.

However, the new approach still allows for artificial haircuts to the impact on derivatives that are held on balance sheet date. This is inappropriate and should change. We also note that applying an arbitrary haircut creates inappropriate risk management incentives. For example -

- It creates incentives to use hedges that are of longer term – these would be less liquid and more expensive and can also create more counterparty and interconnectedness risk relative to using exchange traded derivatives that are of shorter tenor

- Applying haircuts does not recognise the full economic benefit and creates incentive to over hedge, which can lead to losses when markets do well.

GFIA welcomes the IAIS' plans to consider dynamic hedging programmes in the development of ICS version 2.0, as hedging is an appropriate risk mitigation technique.

Stress levels

GFIA remains concerned that the stress levels are overly high in some jurisdictions, particularly in relation to:

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- lapse risk.
- mortality and longevity risk, particularly where there is significant experience in managing longevity risk.
- morbidity/disability risk, where failing to take into account the risk mitigation between upward and downward shocks does not represent the economic reality. Some products respond in the opposite manner to the same drivers of risk, and the current approach does not allow for this. This could go against the diversification policy an entity could promote.
- premium and claims reserve risk, where we recommend the IAIS provides a reconciliation between the final risk factors and those currently in place in IAIS members' respective jurisdictions, and that the same correlation factors are not applied to premium and claims reserve risk.
- operational risk, which is also too complex, particularly on single premium business. Premiums not directly related to insurance risks should be excluded from the operational risk premium charge calculation.
- interest rate risk, as the time-period used to calibrate the interest rate stress is very short, and could result in pro-cyclicality. This could be addressed by lengthening the time period used to calibrate the stress, i.e. cover multiple economic cycles, and introduce mechanisms to reduce the stress in falling or low interest rate environments. The current methodology for interest rate risk is also overly complex and the IAIS should consider simplifications, while retaining the risk-based calibration objective.
- equity risk, where an additive approach to equity volatility stress should be used.
    - An additive approach would help to reduce pro-cyclicality, and a countercyclical measure should also be introduced to reduce short-term-procyclicality behaviour during stressed periods.
    - The absence of look-through on hedge-fund/private equity assets also contributes to very high equity risk calibrations. Therefore, the IAIS should envisage a look-through approach to investment funds.
    - If the IAIS decides to keep a volatility stress, then this should be reflected in the equity price stress as the two are not independent and therefore cannot simply be summed up. An approach that requires two different stresses, distinguishing between price and volatility stress, is unfounded, and could lead to an exaggerated capital requirement by double counting the risk to be covered in this risk module.
    - Long-term and strategic equity investments should have appropriate treatment with tailored calibration. Where equity investments are made to be held long-term, the calibration should take into account exposure to long-term market risk. The standard equity calibration cannot simply be

adapted to long-term investments where these have specific characteristics (higher quality, lower volatility, long term holding and strategic feature) that should be given proper recognition.

- currency risk, as the majority of the risk currently captured relates to currency translation risk, and GFIA considers it is doubtful that this could have a material impact on policyholder protection, and therefore too much capital is being held for this risk. There are also material differences in currency risk charge on the liability side due to different valuation methods producing different currency exposures.
    - This outcome reduces comparability between insurers, and results in significant differences in the capital required depending on the currency it is held in. This is contrary to ICS Principle 1, which requires that the amount of capital required to be held should be “irrespective of the location of its headquarters”. Participating products in particular can absorb a decrease in the value of foreign assets due to ALM rules. We suggest having the capacity to take into account absorption of shock in gross risk charge by liabilities.
- credit risk, where management actions should be considered, especially for life insurers and with-profits or unit-linked contracts where insurers share losses with policyholders.
    - The IAIS should recognise that, where products are designed so that investment risk is fully or partially transferred to policyholders, insurers are not exposed to market/credit risk of these investments. Therefore, no capital requirement for holding assets should be foreseen whenever investment risk is borne by policyholders via product design.

We would invite the IAIS to consider defining more appropriate stress levels, with reference to the input from stakeholders including historical data obtained through 2017 field testing.

Catastrophe risk

GFIA strongly supports the use of models for catastrophe risk, including partial internal models. This approach confirms the challenges and difficulties of adequately reflecting the diversity of cat risk through a standard formula.

While we support the objective that catastrophe models result in a fair assessment of natural catastrophe risk, we do not think that this assurance should be sought in the form of a requirement within the ICS. If catastrophe models are allowed in the IAIG’s jurisdiction, the ICS should also allow for them. The key ingredient in achieving a fair assessment of natural catastrophe risk is in fact the allowance of the use of catastrophe models in itself, as this ensures that the ICS reflects an IAIG’s actual exposure to natural catastrophe risk.

Considering the context of the latent liability scenario, IAIS should remove inappropriate risk charges on property lines and certain liability lines, such as workers’ compensation. It is important that no significant property liabilities are captured in this stress, or that the shock is appropriately adjusted. Segmentation/shock levels should be selected to ensure no liability lines potentially containing significant property exposure are included erroneously, as these shocks are significant in many cases (as high as 75% of net earned premium). An adjustment should also be made to latent liability for double-counting with premium risk and claims reserve risk.

Aggregation/diversification

We believe there is conservatism attributable to the structure and calibration of the aggregation model, and GFIA is concerned that the proposed diversification benefits are quite limited. For example, there is no allowance for geographical diversification within the EU, the US, or other segments. Similarly, lines of business are grouped at quite a high level, and a more granular approach would more appropriately reflect the economic reality of a diversified portfolio.

Tax

The consideration of taxes is critical to many GFIA members. GFIA welcomes the IAIS' indication that the consideration of taxation will be subject to further stakeholder discussions as part of the ICS development. The recognition of the recoverability of deferred tax assets as an attenuation effect on ICS requirements, and of application of tax deductions on losses post-stress, should also be considered.

Reporting

The ICS proposes burdensome, very detailed reporting requirements. GFIA doubts that such a volume of detailed information would be reviewed by supervisors on a timely basis. The IAIS should reduce the volume and the granularity of the information required, to be more focused on the main issues. Taking into consideration the experience under existing regimes is necessary to avoid burdensome reporting requirements.